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DEFENSE CONTRACT AUDIT AGENCY REPORT ON USE OF CONSULTANTS BY DEFENSE CONTRACTORS

HEARING

BEFORE THE

SUBCOMMITTEE ON FEDERAL SERVICES, POST OFFICE, AND CIVIL SERVICE

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

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DEFENSE CONTRACT AUDIT AGENCY REPORT ON USE OF CONSULTANTS BY DEFENSE CONTRACTORS

TUESDAY, DECEMBER 13, 1988

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL SERVICES,
POST OFFICE, AND CIVIL SERVICE,
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee convened, pursuant to notice, at 9:33 a.m., in room SD-342, Dirksen Senate Office Building, Hon. David Pryor, Chairman of the Subcommittee, presiding.

Present: Senators Pryor, Stevens, and Bingaman.

OPENING STATEMENT OF SENATOR PRYOR

Senator PRYOR. Senator Stevens is going to be here. We hope that two or three more Senators will come. In view of time and the fact that I have to catch a plane later on today, I will go ahead and convene the hearing. I have a terrible cold, but I have a pocketful of kleenex here, and I will do my best to carry on.

I would like to thank and welcome our witnesses this morning.

This Subcommittee is looking at an investigation performed by the Defense Contract Audit Agency, or DCAA, into the improper and possibly illegal use of private consultants by large defense prime contractors.

Last summer, we held hearings that focused primarily on the use of private consultants who work directly for the Pentagon. We call these people "direct hire" consultants.

At issue today are the activities of those consultants who are hired by defense contractors, charged to the Pentagon, and whose costs ultimately are passed on to the taxpayer.

Several such "indirect hire" consultants are under investigation at this time in connection with the massive FBI-grand jury Pentagon probe code-named "Ill Wind".

Although consultants certainly perform legitimate functions, the "Ill Wind" probe suggests that consultants may also be involved in criminal activities involving bribery, fraud, collusive bidding, and trafficking in confidential material.

After 6 months, the grand jury is still considering issues raised by "Ill Wind", and today's DCAA audit may give us a clue why it is taking so long. DCAA found that roughly one-fifth of all consultant costs charged to the Government by 12 defense contractors were at best questionable and at worst criminal.

In other words, the Government may be getting ripped off to the tune of possibly 18 cents on the dollar whenever the defense industry charges us for their use of a consultant.

The audit team found that the contractors have charged the taxpayers millions of dollars so the contractors could lobby Congress on defense projects, lobby the Pentagon on weapons contracts, launch PR campaigns, defend themselves in Government court cases, "entertain," and promote private international arms sales—all at the public's expense.

Last summer, we were shocked by the lax controls and monitoring of direct hire consultants at the Pentagon. This study shows that in the sister world of consultants on the payroll of military contractors, the story might be even worse. It also suggests that the much bally-hooed theory of this Administration, that defense contractors or consultants will police themselves without strict controls is, as I believe, a pipe dream.

Today we are going to get into specific cases of abuse and illegalities that are behind the DCAA report. These cases often involve reputable companies and former high-ranking U.S. and foreign government officials. However, the names will be omitted at the request of DCAA and because the primary culprits here are the contractors who charged those consultant costs to the Government.

We are also going to find out what effort DoD is making to address the specific problems raised in the DCAA audit report and what steps are being taken to ensure that tighter controls are imposed on the use and the monitoring of consultants.

Let me give the highest praise to Mr. Reed and to his agency, DCAA. This is one of the finest and most helpful documents I have read from this office. Let me also compliment Dr. Costello's acquisition office for supporting this particular study. I hope that we can agree on some active measures to address these problems.

There are other issues that relate to the particular one that we are looking at today—the "revolving door" issue; foreign agents and sales, and how those foreign agents are paid and by whom; the so-called "buddy system" that we see throughout the consulting world; illegal costs which are passed to the taxpayer; possible conflicts of interest—those consultants who may be working for the private se at the same time; and finally, the De-
partment of Defense management philosophy, which I hope to discuss this morning.

Senator Sasser, who could not be here this morning, has requested that we submit his statement for the record.

[Senator Sasser's statement follows:]

OPENING STATEMENT OF SENATOR SASSER

Mr. Chairman, I commend you for holding this important hearing today. I am pleased to be here to look into the matter of Department of Defense contractor consultant costs. The Defense Contract Audit Agency [DCAA] special audit task force has made some significant findings and far reaching recommendations which will help control misdirected consultant expenditures by our Nation's defense contractors. I am eager to hear more about those from the special task force and I look forward to the comments of Ms. Spector of the Office of the Assistant Secretary for Acquisitions and Logistics with regard to this report.

Recent estimates place the total Federal dificit figure at 144 billion dollars. During these days of budget austerity when many of our vital Federal programs are in danger of deeper cuts, we must continue to be aggressive in our efforts to root out waste, fraud, and abuse in Government. No department or agency can be exempt from such scrutiny.

Currently, some $300 billion a year is spent on national defense. Our military procurement system, which is at the heart of our defense buildup, requires a continuing audit process by which our major weapons systems are built and maintained. Today's findings suggest that the Government must do a better job of insuring that defense consultant expenses are proper and necessary.

Congress has already held extensive hearings on the procurement process, and more work will be done in the next Congress in this regard. Since the broad Government investigation of defects in our military procurement process became public knowledge in June of this year, the Department of Defense and many major defense contractors are carefully scrutinizing the use of defense consultants and the ways in which such consultants may improperly affect the procurement process. The Department is to be commended for acting swiftly in this regard.

Today the focus is on the Defense Contract Audit Agency task force report on the use of consultants by defense contractors. I understand that 18 percent—or $43 million worth—of the consultant costs incurred by the defense contractors examined were "questionable"—meaning there is a good chance these charges should not have been passed on to the government. Several cases may have involved criminal activity. Others revealed failure to comply with regulations designed to insure accountability through documentation and inadequate competition. Clearly, corrective legislation may be in order.

Senator PRYOR. We have two witnesses this morning—first, Mr. William H. Reed, the Director of the Defense Contract Audit Agency. He will be accompanied by Mr. Bernard Topf, the Regional Director of the Defense Contract Audit Agency, Western Region.

Would Mr. Reed and Mr. Topf please come to the witness table?

Once again, I applaud your report. I look forward to your statement this morning.

TESTIMONY OF WILLIAM H. REED, DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, ACCOMPANIED BY BERNARD TOPF, REGIONAL DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, WESTERN REGION

Mr. REED. Thank you, Mr. Chairman.

I am pleased to appear before you and this Subcommittee to discuss DCAA's role in the review of consultant costs charged to Department of Defense contracts.

I previously appeared before this Subcommittee on July 8th of this year to testify on DCAA's responsibilities, procedures, and the applicable regulations relating to the review of consultant costs charged to Government contracts.

Today, I will address DCAA's special audit of defense contractor consultant costs that resulted in our report dated October 24, 1988.

As you noted, appearing with me is Mr. Bernard Topf, DCAA's Western Regional Director, and the Task Force Director of this special audit.

As one of a number of actions taken by the Secretary of Defense in regard to the procurement investigation, DCAA was directed on July 25, 1988, to form a task force to conduct an audit of contractor consulting costs. In making this request, Secretary Carlucci noted that recent disclosures of possible abuse by contractor consultants to improperly influence the acquisition process are of serious concern to the Department of Defense; that costs to exert such influence are clearly unallowable as charges to defense contracts; and

that diligence must be exercised to assure that costs are not included in defense contracts, and referrals for investigations of abuse are made where applicable.

Specifically, the Task Force was asked to conduct an audit of a representative sample of large defense contractors to determine the nature and extent of consulting costs charged to defense contracts. The audit results were to be furnished to the Undersecretary of Defense for Acquisition for forwarding to the Secretary along with recommendations for any needed modifications to the regulations.

A task force was formed consisting of Mr. Topf and three regional audit managers from DCAA's Eastern, Mid-Atlantic and Central Regions. The Task Force made the contract selections, defined the auditing plan, organized the supporting audit elements and provided managerial direction throughout the review. The actual audit work at each contractor location was carried out by staff members of the cognizant DCAA field office.

In arriving at the selection of contractors for audit, we examined the top defense contractors to identify those who had submitted recent certified indirect cost submissions. Also, we considered the contractors' products and services, programs and primary DoD procurement sources. Our objective was to select a representative sample which was not skewed toward a particular product, military service, or procurement activity.

The 12 companies selected received 32 percent of prime defense contract awards in fiscal year 1987 and supply a wide variety of goods and services to the Army, Navy and Air Force. They also rank in the top 25 defense contractors in terms of cost-reimbursable and fixed-price incentive contracts.

Within the 12 selected companies, we chose for examination those segments with the most significant incurred costs on cost-reimbursable and fixed-price incentive contracts, the group headquarters, and if applicable, their corporate office. A detailed examination was made of those costs incurred in the latest year for which a certified claim had been received when our review began in early August 1988.

At the onset of our review, we encountered significant difficulty in isolating "consulting" services and costs due to the lack of a universally accepted definition of the term. The Federal Acquisition Regulation, the governing cost principle, addresses professional service costs together with consultant costs without distinguishing between the two. Further, contractors had no routine means of separately identifying or accumulating these costs. Consequently, we determined that all costs covered by FAR 31.205-33 should be examined in order to reduce the risk that a misunderstood definition would result in the exclusion of pertinent items.

Investigatory methods are beyond the scope of auditing procedures and were not applied in this review. Therefore, we placed principal reliance upon contractor-supplied documentation—primarily, the agreement or the contract between the contractor and the entity performing the service; the work products, and the billing documents—to determine the nature of the costs and whether the costs were allowable in accordance with FAR 31.205-33.

Absent some indication in that documentation or a clear inference from it, we had no means to ascertain whether the services

involved the possible exertion of improper influence on the acquisition process.

A copy of our entire report has been submitted to the Subcommittee;[1] therefore, in the interest of time, I would just like to highlight the major conditions and recommendations.

We found that contractors were spending considerable sums supplementing virtually every in-house activity with professional and consultant services. During the periods reviewed, $237 million of such costs were charged either directly to defense contracts or included in indirect cost claims. Legal, engineering and financial services accounted for $163.9 million, or approximately 69 percent, of that total, while lobbying, sales/marketing and management services accounted for $51.2 million, or 22 percent. The balance of the $237 million involved numerous other types of service, some of which could not be identified.[2]

Auditors concluded that $57.6 million of these costs were questionable under various Federal acquisition regulation cost principles. Most of these questionable expenditures represent claimed costs where the contractor could not produce evidence of services rendered or, to a lesser degree, could not produce written agreements as to the value and type of service being purchased.

In a number of cases, contractors stated they will ultimately be able to locate and produce adequate support for some of these costs. We believe contractors should have had such support readily available before including these costs in certified overhead claims. Approximately $43 million of the questionable costs were charged to DoD contracts of all types. Of this amount, $19 million would be reimbursed on DoD flexibly-priced contracts if allowed.

In addition to the questionable costs, we found examples of weaknesses in every significant internal control area related to professional fees and consultant costs. A list of deficiencies include: one, determination of need, selection of source, determination of fee, monitoring of services, all performed by a single individual or organization; two, absence of a written contract; three, description of services to be performed were inadequate to ascertain the appropriate accounting treatment, to monitor the performance, or to determine the allowability or identify whether the fee is a retainer or for specific services; four, absence of documentation demonstrating that service was unavailable in-house or that such availability was considered; five, absence of evidence of competition in selection of the firm; six, absence of evidence that fees were reasonable in view of the services procured; seven, lack of an adequate accounting review to ascertain accuracy of accounting classification; eight, failure to adhere to existing company policies and procedures; nine, failure of internal audit to examine operation of internal controls in this area.

As a result of these conditions, our report included the following recommended actions:

FAR 31.205–33 should be revised to strengthen unallowability criteria, clarify the documentation required to support claimed cost, and better define professional fees and consultant costs.

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[1] See p. 35.

[2] See pp. 59 and 60 for charts submitted by Mr Reed.

Contracting officers responsible for settlement of final indirect cost rates should assure that $19 million of claimed cost is disallowed unless additional support is submitted and reviewed by DCAA.

Contracting officers and DCAA auditors at individual contractor locations need to aggressively pursue contractor correction of internal control weaknesses over the approval and control of consultant costs and cost-estimating procedures used to propose such costs.

Contracting officers should assure that contractors fulfill their responsibilities to delete unallowable cost from their claims to the Government in accordance with FAR 31.201-6 and to demonstrate to DCAA that such screening properly deleted directly associated costs as well as the unallowable costs themselves.

Since forwarding of this report to the Undersecretary of Defense for Acquisition, actions have been taken or are in process on all of our recommendations. In addition, DCAA plans to accelerate our consultant reviews at major cost centers of the next 18 largest contractors. Like the prior reviews, these audits will cover the most recent contractor fiscal year for which we have received a certified cost submission. Field work at these new locations will be completed by February 28, 1989, with reports being issued within 60 days thereafter.

Following these additional accelerated reviews, consultant costs will continue to be a high-priority item when performing incurred cost audits at all contractors.

Mr. Chairman and Members of the Subcommittee, that concludes my statement. Mr. Topf and I would be glad to respond to any questions you may have.

Senator PRYOR. Mr. Reed, thank you very much.

We are very pleased to have been joined by Senator Stevens of Alaska. Senator Stevens, do you have a statement or any questions.

Senator STEVENS. Thank you very much.

I have long been wary of some of these overseas costs. Let me ask you one basic question. As I understand your statement, all of these costs are subject to review, and unless they can be justified, they will be charged back to the contractor, is that right? None of these have been lost in terms of the recovery process, so to speak, is that right?

Mr. REED. That is not exactly correct. Nineteen million dollars of the costs that have been questioned are charged to flexibly-priced contracts, and those, we have not lost. We have the opportunity to challenge those costs and to disallow them.

Costs, however, that are charged to firm fixed-price contracts, we have no mechanism to recover those costs. Our opportunity to eliminate such costs in firm fixed-price contracts is when the contract price is being established and negotiated. In those contracts, we have no remedy at this point on these unallowable costs.

Senator STEVENS. Well, on those contracts, if the contractor exceeds the estimate, they are going to eat the costs anyway, right?

Mr. REED. That is correct.

Senator STEVENS. But as I understand it, some of them do substantiate the costs, even under the fixed contract?

Mr. REED. Yes, sir, that is correct.

Senator STEVENS. You have indicated that there are a series of these contracts on which there is not adequate data. So, those could not be charged to contract, even under a fixed-fee contract, if they do not have documentation, can they?

Mr. REED. Yes, they could be. The documentation requirement is when the price of the contract is being originally negotiated and set. At that time, the contractor is required to submit cost or pricing data to support what he is proposing as the cost of that contract.

The Government has an opportunity to review that data and negotiate the price. Once the price is set, there is no basis to adjust that price thereafter.

What we need to focus on as a result of this review is whether or not we are getting adequate supporting data, cost and pricing data, when firm fixed-price contracts are being negotiated. That is the direction I am giving to my auditors. We have to be more careful in reviewing cost or pricing data of firm fixed-price contracts in the future to make sure these kinds of costs are properly supported.

Senator STEVENS. I see. In other words, if you enter into a fixed-price contract, one of the aspects would be that the contractor would not have to keep the details he would have to have if they were not on a fixed-price contract, is that correct?

Mr. REED. That is correct. Once we establish that $1 million is a fair and reasonable price, regardless of what makes up that million dollars, he is going to be paid a million dollars for that service.

Senator STEVENS. I was concerned with the top line—$37 million of the $57 million is lack of adequate agreement or work product. Now, how can you break that down between fixed-price and non-fixed-price contracts?

Mr. REED. The estimated amount that was charged to DOD contracts there, of $43 million, approximately $19 million of that amount would go to flexibly-priced contracts.

Senator STEVENS. I see. In terms of your review, is part of the work product of your review going to be recommendations to Congress on how this process might be tightened up, and we can avoid charging to the taxpayers items that should be absorbed by the contractor?

Mr. REED. No, sir. My recommendations are directed to the Department. The Secretary asked me to make recommendations to him as to ways that he could improve the regulations and controls within the Department, and our responsibility is to monitor these costs. And that is what I have recommended to him.

I believe the actions that have been recommended will adequately address these problems and give us the tools we need as auditors to make sure that these costs either are not claimed or are eliminated where they are.

Senator STEVENS. I may want to review this fixed-price contract again, so I have just one more question along that line, Mr. Chairman.

As I understand you, if a fixed-price contract is entered into, it is not possible to later challenge the costs that were incurred and billed to the Government, even though they may be costs that would be contrary to the regulations if entered into by a non-fixed-price contractor, is that correct?

Mr. REED. That is correct. The only way that the costs could be challenged is under the defective pricing provisions, if the contractor submitted inaccurate, non-current, or misleading information during the negotiation of the price.

In these cases here, we did not go into that step, but that is a possible remedy when these contracts are reviewed for defective pricing. If the cost or pricing data was not complete and accurate in support of the proposed price, there may be a basis to assert defective pricing.

Senator STEVENS. Well, I may have been in error, but I have got to tell you that on another subcommittee that I am on, the Defense Appropriations Subcommittee, that was not my understanding. It was not my understanding that a fixed-price contractor could still charge the Government costs that were contrary to the regulations as far as lobbyists' costs, unallowable seller's fee, and foreign selling costs. I thought we had prohibited that.

Now, if we have failed somehow, I am going to have the Defense Subcommittee review that, but I thought we tied that down—that unallowable costs are unallowable costs, and you cannot charge them to the Government even if you've got a fixed-price contract. If we have not done that right, we'll do it right. But I would ask you at this point in the record to review your comments and see if we have had a meeting of the minds concerning my questions and your answers, because I do not quite understand it that way, and I want to make sure that you get a chance to review that record before we put another group of investigators to work on this.

Mr. REED. I would be happy to do that, Senator.

Senator STEVENS. Thank you very much.

Thank you, Mr. Chairman.

Senator PRYOR. Senator Bingaman of New Mexico.

Senator BINGAMAN. Thank you, Mr. Chairman.

Let me try to clarify my understanding of the situation. As you are describing it, many of these costs that are listed here as questionable are not allowed in the case of negotiated contracts or cost-plus contracts, but are allowed or could be allowed in the case of fixed-price contracts?

Mr. REED. Well, the timing is the issue here. When you negotiated a firm fixed-price contract, the contractor is going to assume the risk of performance at whatever cost. In other words, his reimbursement is not going to be based on his actual cost expended; it is going to be based on the price that we agreed to in advance.

So our opportunity to establish a fair and reasonable price which excludes all of these kinds of unallowable activities is when we negotiate the price of a firm fixed-price contract. After we do that, if we find out that he actually charged some unallowable cost to that contract, you could argue that that does not affect the fair and reasonable price that was set for that contract, because we looked at all the costs that he proposed, and there were not unallowable costs in there. The unallowable costs could be viewed as really being offset against an allowable cost that he did not incur for some reason, or against his profit.

Senator BINGAMAN. Now, the contracts that you audited to arrive at these figures, were they firm fixed-price contracts?

Mr. REED. We audited all the charges that were allocated either directly charged or allocated to DoD contracts of all types, firm fixed-price and flexibly-priced.

We did that because we wanted to answer the Secretary's question about what was the nature and extent of consulting services being charged to DoD contracts. He did not differentiate flexibly-priced versus firm fixed-price.

Senator BINGAMAN. Now, on flexibly-priced contracts, is it uniformly the case that the contracts that DoD enters into do not permit reimbursement for the kinds of costs that you have here? I mean, you have two things on this chart, as I see it—you have things that are questionable because there is not adequate evidence—for example, with the first item, lack of adequate agreement or work product. I guess what you are saying there is that you could not determine from your audit what the contractor did to justify the payment.

Mr. REED. That is correct.

Senator BINGAMAN. So it may have been perfectly okay, and it may not have been.

Mr. REED. That is correct.

Senator BINGAMAN. Further down, you have legislative lobbying costs. Now, I think Senator Stevens' point is one that I would share. My thought is that as a general matter, we probably would not want consultants to defense contractors charging the defense contractors and ultimately the Government for legislative lobbying costs. That does not seem like an appropriate thing to have those folks charge us, regardless of what evidence they have or anything else.

Now, you have put that on your chart as questionable. Why haven't you just put that up on unallowable? Why don't we have two charts here—one, unallowable costs, and one, questionable costs?

Mr. REED. In the audit report, there are different schedules differentiating the costs the way you are describing. There is a schedule of costs which apply only to the overhead costs claimed for allocation to flexibly-priced contracts. This particular schedule includes costs that were charged to both firm fixed-price and flexibly-priced, and therefore we used the word "flexible" because of the distinction that we have been discussing regarding the nature of a firm fixed-price contract versus a flexibly-priced contract.

Senator BINGAMAN. I guess what I'm still unsure about is do we need to change the law, or does DoD need to change its contract provisions to ensure that some of these costs are not charged to the Government under any circumstance.

Mr. REED. I don't think we do. For example, if a contractor is proposing a price to us on a firm fixed-price contract——

Senator BINGAMAN. I know about firm fixed-price, but I am talking about flexibly priced now. On flexibly priced contracts, is there any justification or any reason why the Government should want to pay for legislative lobbying costs?

Mr. REED. Absolutely not. It is an explicitly unallowable cost.

Senator BINGAMAN. Okay. It is explicitly unallowable in the existing law and regulations.

Mr. REED. Yes, sir, that is correct.

Senator BINGAMAN. You list it as questionable, but in fact, anything that is identified as legislative lobbying costs is clearly not chargeable, it is unallowable.

Mr. REED. That is correct. But the amount that is shown up there as legislative lobbying cost was included in indirect costs which are then allocated to both flexibly-priced and firm fixed-price contracts. So it would have been misleading to label that as unallowable cost at the amount stated on that chart, in the sense of what we would say on a flexibly-priced contract.

Senator BINGAMAN. There are several that sort of fall into that category, I would think. Could you tell me what your understanding is of the present laws and regulations with regard to funds expended in defense against Government claims and appeals, I mean, are those generally unallowable costs in flexibly-priced contracts?

Mr. REED. Yes, sir, that is correct. There is a specific cost principle in the acquisition regulations which states explicitly that costs of pursuing claims or defense of claims against the Government are unallowable.

Senator BINGAMAN. Is this the same with the prosecution of claims against the Government?

Mr. REED. That is correct.

Senator BINGAMAN. And is this same with defense of fraud proceedings?

Mr. REED. That is correct.

Senator BINGAMAN. So, to the extent that we can determine that a contractor is charging those, or has a consultant that is charging those to the contractor, who in turn charges them to the Government, those are all items which, in the case of flexibly-priced contracts, are in violation of the regulations.

Mr. REED. They are in violation of the regulations, and these issues are picked up in DCAA's audits and questioned.

Senator BINGAMAN. Okay. And there is no need for a change in the regulations to make that clear?

Mr. REED. That is correct.

Senator BINGAMAN. Is there a need for a change in the regulations to make anything else clear?

Mr. REED. Yes. The first area, the lack of adequate agreement or work product, came about, I believe, because the current cost principle states that contractors must furnish sufficient evidence of the nature and extent of services received from consultants. Many contractors apparently interpreted that to exclude work product evidence—in other words, they felt that the test of meeting that was much less than we viewed it. We felt that in order to determine the nature and extent of services rendered, you really needed to see a written agreement as to what services were being purchased, and you needed to see the product that was provided as a result of those payments in some form, be it a memorandum, a report, a letter—some documentation that someone actually did something for the money that was received.

Consequently, our first recommendation is that that particular cost principle be expanded to explicitly state that evidence of the nature and services rendered must include certain types of documentation. It lists specifically the type of documentation that we think was absent in these situations.

Senator BINGAMAN. Ms. Spector is proposing a change in the regulation to meet that recommendation.

Mr. REED. Yes, she is.

Senator BINGAMAN. Okay.

That's all I have right now, Mr. Chairman. Thank you.

Senator PRYOR. Thank you, Senator Bingaman.

We have discussed regulations this morning to some extent, and I would just like to say in my behalf, I am not proposing we add an inordinate number of new regulations. Here are the regulations, the Federal Acquisition Regulations, and roughly half of these, Senator Stevens and Senator Bingaman, applies specifically to the Department of Defense, if I am not mistaken. So we are not really seeking to add a lot of new paperwork or regulations. But we know that we have a major problem here.

The first question I would like to ask—it is not a prepared question—this audit that you have just completed was mandated by Secretary Carlucci in July of 1988, is that correct?

Mr. REED. That is correct, sir.

Senator PRYOR. And before this time, when was the last audit done that looked specifically at consulting and consulting costs?

Mr. REED. We audit these costs on a routine basis every year. What we had never done before is do it on a national basis, all at one time, and collect all the results from all the different locations in one collective summary-type report.

Ordinarily, the audit office at each particular contractor would perform a review of their overhead expenses and their direct costs, including consultant costs, every year, and submit a report to the contracting officer at that location, who would then negotiate the allowable final rates on contracts for that particular year.

Senator PRYOR. In the past, how many dollars have you recovered for the United States Government and the taxpayer in those previous audits?

Mr. REED. I would have to provide that for the record, Senator.

Senator PRYOR. Not many, though, correct?

Mr. REED. No, sir. I would conclude it has been substantial.

Senator PRYOR. All right. So you are looking at about 12 contractors, who get about 30 percent of the defense work, and you have found some $43 million in questionable costs that they were trying to pass on to the taxpayer, is that the conclusion that we can reach here?

Mr. REED. Yes.

Senator PRYOR. Now, this was the first time you had done such a massive audit. What sort of reception, what sort of cooperation did you get out there in the field when you went to these major defense firms?

Mr. REED. I think I will let Mr. Topf answer that, because he went out on a day-to-day basis.

Senator PRYOR. Mr. Topf, would you try to answer that? You were out there in the field. When you walked in the door, what did they say?

Mr. TOPF. Well, I would say that the response was different at different contractors, and different at different segments of contractors. Many of these contractors have pretty decentralized control, and some have centralized control. So there are a lot of stories

out there. I would say at best, the contractors, given the impetus of the Secretary's request, were cooperative to the extent of working with us, trying to identify the universe.

Keep in mind the first problem we had was the identification of the universe of consultant professional services costs, because contractors do not have an account that says "consultant" and that's it, and every consultant gets charged to it. Consultants are charged throughout a series of accounts. Professional services are charged throughout a series of accounts. And, as Mr. Reed explained, there is no differentiation in the FAR, so we had to look at both.

So some contractors were very cooperative in trying to identify that universe; others pretty well stonewalled us and did not attempt to identify it.

Senator PRYOR. Let me ask you about a quotation from page 1 of the audit report of DCAA, and let me ask you to elaborate. "Widespread contractor resistance was encountered to DCAA access to information on unclaimed cost needed to determine that contractors had screened out related directly associated costs, as required by FAR."

Mr. TOPF. Right. I was going to get to that, Senator. I may as well cover that now.

Senator PRYOR. Why did they resist?

Mr. TOPF. They resisted because—what you are looking at up there, that schedule, is the schedule of questionable costs related to claimed costs. There is also a schedule in the audit report—a fairly large amount of money—of unclaimed costs. And in those unclaimed costs might be anything. We know there are significant amounts of consultant costs that have not been claimed by contractors. Aside from the connotations of Operation "Ill Wind," where many of the people who have been mentioned in the media were in unclaimed costs as well as in claimed costs, we also have a responsibility to determine whether or not a consultant who is not claimed and therefore not charged to Government contracts may well have incurred costs which the contractor has claimed. It may say $25,000 a month plus expenses, and the expenses could be a secretary provided or support services provided by the contractor, and these particular costs could be in allowable accounts. So we feel very strongly that we do need access to contractors unclaimed costs. I think we encapsulated it pretty clearly in the report.

Senator PRYOR. Now, Mr. Topf and Mr. Reed, both of you are American taxpayers, and by April 15, we assume, you send in your tax return. When you take a deduction, you have the burden of proof for furnishing the facts to justify that deduction. Does the contractor have that same burden of proof to justify the costs that are being passed on to the taxpayer in this process? Is that same burden there?

Mr. REED. It certainly is, and as we noted in the audit report, we were surprised at the lack of adequate agreement in work product support for a large amount of these costs.

Senator PRYOR. All right. Now, the taxpayer may go to jail or he may get a big penalty, a certain percentage of the debt if he cannot justify it. What happens to the contractor? What punitive actions can be taken? What penalties? Is there interest collected on that debt, if it is ultimately collected? Describe that to us.

Mr. REED. Well, for contracts awarded after March of 1987, there is a new clause which does apply penalties with interest on unallowable costs of this nature that are claimed on our contracts. The special audit we are discussing today primarily affects contracts which were issued prior to the new clause.

So in the future, we do have a mechanism, a regulation in place which affects contracts awarded after March of 1987, which will assert penalties with interest for claiming unallowable costs.

Senator PRYOR. All right. Now, out in the field, when you looked at these 12 defense contractors, and I assume you were in many of their regional offices across the United States, have you found that any of the consultants hired by the contractor to perform a service were also doing work at the same time for the Department of Defense—were they working both sides of the street?

Mr. REED. I'll answer and then let Mr. Topf add, if he would. I do not believe we had the capability to determine that when we looked at——

Senator PRYOR. In all these rules and regulations about acquisition, doesn't a conflict of interest just jump out at you on this? It is pretty incredible to me.

Mr. REED. Well, we are certainly aware of the current concern over conflicts of interest and the considerations that are being given to such things as registration and certification and——

Senator PRYOR. All right. Question: Did you, and once again, I applaud your work, find any of these consultants hired by the defense contractors also working for, at the same time, foreign governments? Did you uncover any of that?

Mr. REED. Once again, I would have to say no, we did not, because we would have no capability of cross-checking something like that.

Senator PRYOR. All right, next question: Do you have any way of cross-checking in your examination of these thousands of documents at 12 defense contractors, did they hire consultants who were convicted felons? There is no way to determine that, is there, because there is no cross-check?

Mr. REED. Not in the kind of procedures that an auditor follows; you cannot determine that kind of information.

Senator PRYOR. And there is no registration.

Mr. REED. That is correct.

Senator PRYOR. So there is no way to know who these people are working for.

Mr. REED. That is correct.

Senator PRYOR. Now, we have looked at 12 contractors who have received a quarter of a billion dollars, basically. How many consulting dollars are there among the other defense contractors? How many consulting dollars are out there?

Mr. REED. I cannot give you an exact answer, but I can make some observations. First of all, in addition to the 200 and some million dollars that we identified here, there was another $130 million at these 12 locations which was voluntarily deleted. So even——

Senator PRYOR. What do you mean by "voluntarily deleted"?

Mr. REED. These are consultant costs that the contractor incurred himself, but chose not to claim against his Government contracts.

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Senator PRYOR. I see.

Mr. REED. A second observation would be these are among the 12 largest defense contractors in the country, and they represent some 32 percent of the prime contract awards. I do not think you could just multiply it by, say, a factor of 3, but certainly, I think the amount has got to be considered in the billions.

Senator PRYOR. Now, Mr. Reed, you are a fine public servant; you have absolutely impeccable credentials. Didn't you go home at night after this report was finished and say, "This problem is bigger than we think"? Do you ever have feelings like that?

Mr. REED. I have feelings like that all the time, and that is what my job is all about, finding problems——

Senator PRYOR. Is this the tip of the iceberg?

Mr. REED. We certainly think it is, and that is the reason we are immediately expanding this review to 18 more of the larger contractors, and we are going to be hitting consultant costs in our audits very hard in the future, believe me.

Senator PRYOR. I am going to yield to Senator Stevens.

Senator STEVENS. I have no questions, Mr. Chairman.

Senator PRYOR. Senator Bingaman?

Senator BINGAMAN. Just to try to clarify some confusion here on firm fixed-price contracts, why are people keeping track of what their costs? So that you can audit? What is the relevance? If I have a firm fixed-price contract, if the Government has signed the contract for $1 million and hired me to do something for $1 million, I guess it is important after the fact to know whether the Government made a bad deal. I mean, if 50 percent of that $1 million turns out to be profit, and they really should have entered into a cheaper contract, that would be useful information. Except for that, what is the relevance of looking to see whether you made a bad deal after the fact? I mean, why are you auditing the costs that people incur in performing on fixed-price contracts? I just don't see that there is any prohibition; you can incur any costs you want, or fail to incur any costs, or take 75 percent of it home as profit, or do anything you want if it is a firm fixed-price contract, can't you?

Mr. REED. Well, you have to remember that we are looking at both direct and indirect costs in our audits. Indirect costs, of course, are allocated across a base of all work—commercial, firm fixed-price, fixed-price incentive, and cost type. Therefore, a transaction in the overhead is tested for allowability, and once allowability or unallowability is established, then the impact to the various types of contracts making up the base is determined.

Likewise, if we are looking at direct costs, we audit a contractor's system for recording his costs. We want to know whether his costs are being recorded consistently. In other words, if he charges legal fees direct to a Government contract, does he charge similar legal fees direct to his commercial work and his firm fixed-price contract—or, does he charge it into overhead?

In order to make those kinds of determinations about consistency and allocatability, you have to look at all the costs.

In addition, the contractor is required to comply with the Truth in Negotiations Act with defective pricing, which gives us the authority to go back in and examine his actual costs incurred on firm fixed-price contracts in order to determine whether the cost and

pricing data he submitted as a basis for negotiating that price was current, accurate and complete.

Senator BINGAMAN. Okay. You also testified that since, I guess, the middle of last year, penalties with interest are chargeable on unallowable costs that contractors incur. In your view, is that provision that imposes penalties with interest adequate to dissuade or deter the practice of charging unallowable costs? Or is something more needed?

Mr. REED. By itself, it probably is not. But we have a number of things that are going on. First of all, we have overhead certification, which we held high hopes for and which has helped—it did not help in these cases, obviously, because some still got through. We also have considerable effort by the defense industry to clean up their act. It is important to note that these are 1986–87 costs that we are looking at here, before a lot of the current self-governance initiatives were started by companies, and companies themselves, quite frankly, in the claims that they are preparing today are doing a much better job of screening out the unallowable costs than they did back in these prior years.

But that is not to say that they should not have done a better job in these years as well, because they did sign a certificate that, to the best of their knowledge and belief, they were not claiming any unallowable costs.

Senator BINGAMAN. How does that certificate that they sign, saying that to the best of their knowledge and belief, they were not claiming unallowable costs, differ from the overhead certification that you say is going to improve matters?

Mr. REED. That is what I am talking about. They did make the overhead certification.

Senator BINGAMAN. Now, what is the sanction or what is the penalty for certifying something that turns out not to be the case?

Mr. REED. Well, if we have information which leads us to believe that the statement is false, then that is subject to investigation for perjury.

Senator BINGAMAN. But you would have to demonstrate not just that the costs were in fact unallowable, but that they intentionally charged costs that they knew were unallowable.

Mr. REED. That they had knowledge, or there was a reasonable basis to conclude they had knowledge or should have had knowledge.

Senator BINGAMAN. That is a pretty tough burden of proof on you or on the Government to demonstrate that someone not only charged costs that they shouldn't have charged, but that they intentionally did it, knowing it was wrong.

Mr. REED. That is a tough burden, yes.

Senator BINGAMAN. So really, the only concrete penalty that has been added, or the only concrete disincentive that has been added, is this penalty with interest that can be charged on unallowable costs regardless of whether they were put in with good faith or not. What you are saying now is that under the new regulations, you can go ahead and charge penalties and charge interest, or the Government can—the Department of Defense can charge penalties and charge interest on unallowable costs regardless of whether the

company thought they were doing the right thing or didn't think they were doing the right thing or anything else.

Mr. REED. One point of clarification on that. The penalties apply to unallowable costs which are explicitly unallowable. In other words, the penalties would not reach to areas of disagreement. For example, the auditor may say, "We believe this is legislative lobbying." The contractor may argue, "No, this was not lobbying; this was providing requested information"—in other words, these issues are not always crystal clear as to whether they meet the test of allowability or not, and they are subject to negotiation.

In those instances, the penalty would probably not be asserted. So there is another judgment involved that the contracting officer would have to make to assert the penalty—in other words, was the cost explicitly unallowable to the extent that the contractor should not have claimed it. If there is a reasonable doubt as to whether the cost is allowable or unallowable, the penalty would probably not be asserted.

Senator BINGAMAN. So it is really within the discretion of the Department of Defense to decide whether they think it is so clearly unallowable they should impose a penalty——

Mr. REED. That's correct.

Senator BINGAMAN [continuing]. Or, whether it is so questionable that they should not impose a penalty.

Mr. REED. That is correct. And I believe that is a fair way of applying it, because many of these issues are not crystal clear as to the nature of the cost.

Senator BINGAMAN. Okay. Let me just ask once more and then I will quit, is there something more that you think needs to be put into the law or the regulations to discourage the charging of unallowable costs, in addition to this penalty and interest provision?

Mr. REED. I do not believe so at this time. The penalty and interest provisions are really just going to start becoming effective in the near future, and it remains to be seen how effective that will be, and I think we need to see that first.

Also, as I say, I am very encouraged by what I am seeing the defense industry doing today versus what they did back in 1987 to screen these costs better. Believe me, they have gotten the message that we are not going to stand for the same kind of practices that have gone on in the past.

Senator BINGAMAN. Thank you, Mr. Chairman.

Senator PRYOR. Thank you, Senator Bingaman.

Mr. Reed, we were furnished the names of the consultants and their firms which we will not, because of the grand jury investigation, reveal. The list contained the types of fees that the contractors ultimately passed on or attempted to pass on the taxpayer. One of these firms, and I am quoting, listed items such as "golf fees" and "entertainment expenses." The consultant agreement was not clear as to the type of entertainment provided, however.

Then we have one I found to be of great interest, and I imagine this is quite common, vouchers in support of expenses identified as entertainment and lobbying for purposes of "enhancing contractor's image with the Department of Defense." That was passed on to the taxpayer.

Now, we have looked at these 10 firms and 10 individuals, and we only find 4 of the 10 who were actually registered as lobbyists. Doesn't that strike you as a little bit interesting?

Mr. REED. It does not surprise me one bit. I think in our audits, we have uncovered quite a bit of activity that we consider to be lobbying which is being done by nonregistered lobbyists. And if you look at how many registered lobbyists there are in these major companies as compared to the size of their Washington offices, you immediately have to raise your eyebrows with a degree of skepticism.

Senator PRYOR. How much self-policing do you see out there, Mr. Reed, in the private sector of the consultants and the private defense contractors? How much self-policing is out there?

Mr. REED. There is a significant amount of activity currently going on throughout the defense industry——

Senator PRYOR. Is this because of the "Ill Wind" investigation?

Mr. REED. It is because of "Ill Wind"; it is because of some of the prior convictions that the Department——

Senator PRYOR. P-r-i-o-r?

Mr. REED. Yes. [Laughter.]

Obviously, we have had some major, major settlements and convictions or pleas in this past year, very huge amounts, in the hundreds of millions of dollars, which have really, I think, opened up some eyes in the defense industry that they are taking an unacceptable risk in claiming some of these types of activities or doing some of the things they have been doing.

Senator PRYOR. But up until now, there has been no risk, no real penalty up until 1987, is that correct?

Mr. REED. Well, in the sense of regulatory adjustment. The self-policing, I think, is being more motivated by the criminal prosecutions of people who are stepping over that line, for example, the recent publicity which announced a $115 million settlement with a major defense contractor, and another one prior to that was in the $90 million range. Both cases started with accounting and auditing issues that were developed by DCAA in these kinds of audits. There was sufficient reason in those cases to call in the investigators and take it to the next step. That is what has industry concerned, and that is why they are really becoming much more aggressive in self-policing.

Senator PRYOR. Does the Inspector General at DoD or the Office of Ethics or your office have an amnesty program for these people who come in and say, "We have been bilking the poor, old taxpayer. We have been charging for golf fees, entertainment and lobbying, and before we get caught, we want to confess, here is the money"—do you give them amnesty?

Mr. REED. We certainly do not.

Senator PRYOR. How many of them have come in?

Mr. REED. There have been a significant number of voluntary disclosures. I believe the number is in the area of 130—do not hold me to that exactly—voluntary disclosures to the DoD IG. Now, these voluntary disclosures are not being treated as amnesty programs. We are going after the money with vigor. The IG is insisting that there be penalties leveraged against the guilty parties and prosecutions in some cases. Companies have been suspended tempo-

rarily, however, no permanent suspensions or debarments have been imposed at this point. But it certainly can in no way be construed as an amnesty program.

Senator PRYOR. Now, after the news articles and publicity broke on the "Ill Wind" investigation, several contractors doing business with the Department of Defense were debarred, am I correct?

Mr. REED. I think I would suggest that we let Ms. Spector, perhaps, address that more accurately than I could. I have read some news accounts, but I do not have specific details.

Senator PRYOR. I will pose that question to her.

Now, this is a touchy subject, but you have listed "foreign selling costs." Give me an example of a foreign selling cost that might be allowable and one that might not be allowable.

Mr. REED. During the years of this review, there were no foreign selling costs that were allowable, because there was a cost principle which specifically said that all foreign selling costs are unallowable.

Senator PRYOR. Senator Stevens or Senator Bingaman?

Senator STEVENS. No questions at this point.

Senator BINGAMAN. I have no questions.

Senator PRYOR. Now, let's say the U.S. Government decides that a contractor has committed fraud, and they sue that contractor. Who pays the costs of that contractor defending itself against the Government?

Mr. REED. It is a two-step process. The first requirement is that the contractor must segregate the cost of defending himself in that particular complaint. The subsequent allowability of that cost depends on the outcome of the investigation and whatever procedures follow. If the contractor ultimately is found guilty or pleads no contest, or in effect admits culpability, the costs are unallowable. If it is subsequently determined that the Government's case was without merit, the costs are allowable.

Senator PRYOR. You really did not find in your investigation many written contracts between the defense contracting firm and the consultant or consulting firm. Is this correct? Mr. Topf may want to answer that.

Mr. TOPF. No. We found a number of cases where there were no written agreements, but more pervasive were cases of very, very vaguely written agreements. When there was a written agreement it was a standard form. I am talking about sensitive consultants, not the usual professional service firms. A vaguely worded written agreement, for example, would say: Mr. "X" will represent the "Y" company in an attempt to market and sell its products in a worldwide territory. That would be the agreement.

Senator PRYOR. Were you surprised, Mr. Topf or Mr. Reed, at the number of retired military personnel from the Department of Defense and/or high-ranking civilians from the Department who are now working for these firms?

Mr. REED. It didn't surprise me, because there is nothing new about that. In our audits of overhead casts over the years, there have been such individuals, and their specialized experience and knowledge is in great demand by defense contractors. So, no, it did not surprise us.

What did surprise us, if I may, is that the agreements and the documentation of what these individuals were doing was in many cases very, very poor, and that bothered us. Knowing the sensitivity and concern that certainly everyone should be aware of regarding the activities of these people in terms of conflicts of interest from their prior positions.

Senator PRYOR. In doing the report that is the subject of the hearing today, did you find that many of the consultants who were former military or DoD civilians, were retained to lobby or to work with the Department of Defense to influence the Department on particular weapons or policy decisions?

Mr. REED. In specific cases, we did find agreements which specified that was exactly what they were retained to do.

Senator PRYOR. Could you say that again, and maybe put that in your own words?

Mr. REED. We did find situations where former Government employees or military personnel were retained for the specific purpose of maintaining and providing information regarding certain specific programs or weapon systems.

Senator PRYOR. To promote those particular systems?

Mr. REED. That certainly is the context. Now, without having the specific words, I would hesitate to quote the exact language, but the context of the agreements, in some cases, it was very clear that that is what they were being retained to do.

Senator PRYOR. How many of these cases might have been referred to the "Ill Wind" investigators?

Mr. REED. We made five referrals as a result of these audits to the appropriate investigative organizations, and we advised the "Ill Wind" people that we have information. They are so busy that, quite frankly, they haven't gotten to us yet to see what we've got.

Senator PRYOR. I see.

Senator Stevens?

Senator STEVENS. No questions.

Senator PRYOR. Senator Bingaman?

Senator BINGAMAN. Mr. Chairman, could I just ask one other question?

Senator PRYOR. Yes.

Senator BINGAMAN. I would like your comment on this. The word "consultant" is a broad word, and, as you are using the term here, or as we are using it in talking about the figures up here, there are consultants who provide professional services in the sense of scientific capability to supplement that of a company's. For instance, we are talking about a defense contractor's own personnel in being able to accomplish some kind of technological achievement—is that right?

Mr. REED. That certainly is right, and as I noted in my statement, we wanted to point out that our definition that we used in this audit was very broad and certainly did take in such things as legal and accounting services—for example, the annual accounting review for issuing and certifying the financial statements is included in this 200-some million dollars. And the fact that we found widespread use of professional services and consultants should not necessarily be considered a negative thing.

Senator BINGAMAN. The consultants that I think have generally been the subject of the discussion this morning and that primarily are the subject of the questionable items that you've got up here are so-called marketing consultants, aren't they? They are people who are hired by defense contractors not to perform a professional service in the sense of providing some scientific capability or doing an accounting function, but instead they are employed by a defense contractor to help that defense contractor prevail in a bidding process or get a contract or stay informed on something so that he would be in a position to get a contract—am I right or wrong? I mean, when I think of the "Ill Wind"——

Mr. REED. That is not exactly right.

Senator BINGAMAN. Okay. Go ahead and tell me what it is.

Mr. REED. For example, the first line item up there, "Lack of Adequate Agreement or Work Product," probably is primarily in the area you just described, the marketing and selling activity kind of area. The other items up there really cross the whole spectrum of professional services. For an example, you could have a legal firm advising on an organization or reorganization activity within the corporation, a leveraged buy-out or some issue like that, which has no benefit at all to the Government, and we would not pick up that cost. You could have accountants assisting in that. Foreign selling costs could involve professional expertise of all types.

Senator BINGAMAN. But your audit of these particular contractors covered the gamut; you covered all consulting contracts.

Mr. REED. That is correct.

Senator BINGAMAN. Some performed specific identifiable professional services that any firm would go to an outside consultant to perform, and others did these very ill-defined kinds of things that evidently are the subject of this "Ill Wind" investigation. I mean, from what I read in the newspapers, this "Ill Wind" investigation is primarily focused on some of those kinds of marketing activities——

Mr. REED. That is correct. This review encompassed all of the areas that you just mentioned.

Senator BINGAMAN. Okay, thank you.

Senator STEVENS. Mr. Chairman, I do have a question.

Senator PRYOR. Surely, Senator Stevens.

Senator STEVENS. Now, we have gone into this question of the scope of the word "consultant" before. One of the areas I found was that we have the technical representation people—we call them "tech reps"—who come in. A company gets a contract, does provide the system, and then they agree to provide as a follow-up to this system a whole series of people who go with it and make sure it works and service it for a period of time. Those are technically within the concept of the word "consultant." You did not cover that, did you, in terms of your review? You are not covering the people who go with systems and who in effect make sure they work—airplanes and large vessels and everything. I found a couple of tech reps on a vessel out in the Persian Gulf earlier this year. But you are not into that area now, are you?

Mr. REED. Well, first of all, we started from the cost principle which combines professional services and consultant services all in the same cost principle. And we went to the contractor, and we

said, "Identify all the activities in your company which fall within these areas," and the contractors attempted to do that. And as Mr. Topf stated, it wasn't all in one nice little block; it was scattered throughout all of their various cost activities and cost accounts. And they themselves had a tough time identifying what to put into this category.

We then attempted to verify through other sources whether that list was complete. I would say in many cases it probably did include those kinds of people. Engineering services were probably in many cases considered by these companies to be professional services and consultant services.

Senator STEVENS. I see. And you mentioned legal services. Now, did you find non-legal consultants being included in the bills of law firms?

Mr. REED. Not to my knowledge.

Mr. Topf, do you want to comment on that?

Mr. TOPF. Could you repeat that question?

Senator STEVENS. I am interested in whether you found non-legal personnel being included in the bills of law firms. We have seen some law firms here in Washington which have hired non-lawyers to run portions of their consulting business. Are they billing as consultants or billing as legal fees?

Mr. TOPF. To my knowledge, we did not find any—the legal expenses that we looked at were basically legal fees.

Senator STEVENS. All right.

Mr. REED. I think we do know of situations where legal firms have hired accounting firms to support their activities in various areas. We know that is happening. I do not think it came up as a particular issue in this review.

Senator STEVENS. Thank you.

Senator PRYOR. Mr. Reed, does it concern you or Mr. Topf that right now we have no system of cross-checking to see if these consultants hired by the contractors are also working for the Department of Defense, or may be working for a foreign government that had interests contrary to our own, or may be a convicted felon?

Mr. REED. It certainly does concern us, and we are very anxious to see what develops in this area.

Senator PRYOR. Right. Inasmuch as it does, I am wondering if you would assist me in drafting a proposal that this Subcommittee could look at early next year. I do not know whether you want to get into the policymaking business or not, but I offered a consultant registration amendment this fall, and I was not very successful. I hope you will assist us in looking at ways in which we can better cross-check and identify the people and the services that they are performing.

Mr. REED. I know Ms. Spector and I are quite anxious to see what OFPP is going to do under the OFPP Reauthorization Act, which required them to develop policy in the area of registration and certification, and perhaps that can be the springboard for some further——

Senator PRYOR. With all due respect, and she will be testifying in just a moment, I think Ms. Spector opposed my registration amendment in policy last year. But we are going to let her discuss that in a moment.

I want to thank both of you this morning.

Senator STEVENS. Mr. Chairman.

Senator PRYOR. Senator Stevens.

Senator STEVENS. Since you made that request, Mr. Chairman, I think the reason the Chairman's proposal floundered was not because of the wisdom of the proposal, but because of the definition of "consultant." In this process, are you doing anything about defining what the word "consultant" means under your regulations?

Mr. REED. Yes. The cost principle revision that we have in process clarifies the definition that we are using in the cost principle, it expands upon the old definition considerably.

Senator STEVENS. And have you coordinated that through OMB, with Justice and other interested agencies? Can we get a definition of "consultant" this year that we will all agree with, and that you will all agree with?

Mr. REED. I believe Ms. Spector probably can address that better than I can. I am aware that OMB is working on a definition, and I believe Ms. Spector is getting certain information from them and coordinating.

Senator STEVENS. Thank you very much.

Senator PRYOR. Thank you, Mr. Reed and Mr. Topf.

If our next witness will be so kind, we are going to take a three-minute break.

[Short recess.]

Senator PRYOR. Thank you for your patience.

Our next witness is Ms. Eleanor R. Spector, the Deputy Assistant Secretary of Defense for Procurement, Office of the Assistant Secretary for Acquisition and Logistics.

Now, Ms. Spector, we look forward to your statement.

TESTIMONY OF ELEANOR R. SPECTOR, DEPUTY ASSISTANT SECRETARY OF DEFENSE FOR PROCUREMENT, OFFICE OF THE ASSISTANT SECRETARY FOR ACQUISITIONS AND LOGISTICS, U.S. DEPARTMENT OF DEFENSE

Ms. SPECTOR. Good morning, Mr. Pryor and members of the Subcommittee. I appreciate the opportunity to appear before you today to discuss the activities of DoD related to monitoring the use of consultants by prime contractors working on defense projects.

In July of this year, the Justice Department disclosed that it had been investigating the use of consultants by defense contractors and that it found instances of alleged improper conduct by a number of parties.

In response to this disclosure, Secretary Carlucci promptly took several actions. One of his first actions was to send a letter to the chief executives of the 200 largest defense firms, expressing concern that some companies doing business with the Department allegedly had engaged in practices which necessitated investigation.

Secretary Carlucci stated his commitment to take whatever steps are necessary to assure the highest level of integrity in defense contracting and asked each CEO to join him in that commitment.

Another action taken by the Secretary was to establish a Special Task Force to formulate and implement whatever measures might

be required to strengthen DoD controls over contractors' use of consultants and over the related costs.

One measure taken by the Special Task Force was to expedite publication of a proposed revision to the Federal Acquisition Regulation's cost principle governing professional and consultant service costs, which was in process at the time. The proposed revision provided a definition of professional and consultant services, specified the kinds of services that are expressly unallowable, and described the types of supporting documentation that contractors must provide in order to claim consultant costs to be allowable.

The third action taken by the Secretary in response to the Justice Department disclosure was to direct the DCAA to review a representative number of large defense firms to determine the nature and extent of consulting costs being charged to defense contracts.

I will not go into the specific audit findings. Mr. Reed has quite excellently covered those.

I do wish to comment briefly on the further actions the Department has taken in light of the audit findings.

As a follow-up to Secretary Carlucci's July letter, we sent another letter to the 200 largest defense firms, emphasizing that auditors had found contractors' internal controls over consultant costs to be inadequate; that more than half of the questioned cost was attributable to inadequate documentation; that an effective self-governance program requires effective internal controls; and that the CEOs are instrumental in establishing and maintaining those controls to assure that real value results from expenditures on consultant services.

The 12 companies covered by the audit were also provided a copy of the audit report, urged to re-examine their firms' practices, and asked to ensure cooperation with the administrative contracting officer and auditors to resolve and correct the deficiencies. The remaining 188 firms were apprised of additional details regarding the audit findings and asked to review their procedures to assure that internal controls, documentation, and accounting for consultant costs were adequate and effective.

We have also issued a memorandum to the Services and agencies, recommending that they advise contracting officers to be cognizant of the audit findings and to seek prompt correction of any deficiencies and recoupment of funds due the Government.

In closing, I would like to emphasize that DCAA's review report has validated the proposed cost principle change regarding professional and consultant costs to which I referred earlier. The report recommended minor changes to our proposed coverage. It would make the language on documentation more prescriptive by substituting the word "will" for "may," and it would require documentation for actual services rendered on retainer.

We intend to incorporate the changes prior to publication of the final rule. I also wish to emphasize that aside from using the normal review process to continue monitoring activities and costs involving the use of consultants, the Department of Defense is committed to taking whatever additional steps might become necessary in order to assure that questionable practices and excessive costs resulting from consultant use by defense contractors are eliminated.

This concludes my statement.

Senator PRYOR. Thank you, Ms. Spector.

Senator Stevens?

Senator STEVENS. Thank you, Mr. Chairman.

I think, Ms. Spector, you were here when I questioned our previous witness concerning the fixed-price contracts and the costs that we thought we were prohibiting, such as the overseas selling costs for a period.

What is your understanding of the allowability of those costs if they are billed to a contractor under fixed-fee contract?

Ms. SPECTOR. This is the way the negotiation and billing of a fixed-price contract works, a firm fixed price. When we establish the price of that contract, if it is other than by competition—if it is by negotiation—we set the rates at that point low enough to exclude what we believe to be all unallowables. That is done on the advice of DCAA. We negotiate a rate that is sufficiently low that it excludes all predicted unallowables based on historical unallowables, if you will. As the contractor bills for progress payments on that contract, the billing rates are set low enough so that we do not include in those billings rates any unallowables that we note in the course of his performance of the contract.

Now, the ultimate price of the contract, the risk of performing that contract is assumed by the contractor. We do not go back in and adjust that price for anything except defective pricing, where the contractor has given us erroneous data at the beginning to support the negotiation. So that if he overruns in the area of engineering or manufacturing, we do not adjust the price upward; if he underruns in any area, we do not adjust it downward, nor do we go in and adjust the overhead rate for higher or lower incurred overheads.

The billing rates that we pay for progress payments exclude all unallowables so that we do not pay unallowables in the progress payments. The final price includes puts and takes in all areas. We may find additional things; he may also overrun in certain areas.

Senator STEVENS. Well, then, I guess our questions really have to be addressed to the IRS, because it seems to me if we say as a matter of law that certain costs are not allowable under a defense contract, and then they are deducted against the earnings of a contract, that that is where the prohibition would come into play, if I understand what you are saying. And I gather that makes sense, what you have just said.

I have a great deal of problem about the increasing emphasis on these consultants. Do you have a percentage of a firm fixed contract that would be allowable for consultants?

Ms. SPECTOR. No, sir. The way we establish the overall overhead rates—and that is where these types of charges would appear—would be on the advice of the Defense Contract Audit Agency right in the plant. The auditor audits the overhead rate, provides recommendations to contracting people on what the appropriate rate should be for this year and perhaps the next 3 years, if the contract is of that length. That recommended rate is based on what he knows right now on unallowables in the overhead. The rate is normally lower than what the contractor is proposing, for the general and administrative rate, the engineering overhead rate and the

manufacturing overhead rate, and the material overhead rate. Normally, the DCAA recommended rates are somewhat lower than what the contractor is proposing.

Senator STEVENS. I happen to believe that the smaller the size of the potential contractor, the more there may be a need for consultants of the type we are talking about. Take a contractor that has a small plant, say, in my State, and hears about a potential contract—I heard about one the other day. He tries to establish standards for sensitive equipment. That person would have a difficult time understanding how to deal with this enormous Department of Defense without someone literally to advise him on how to prepare a bid or to respond to a request for proposal, as compared to a major company that has people among its employees who are capable of doing this.

I often wonder why so many of these large corporations need these consultants, when I know many of the people who are actually employed by the corporations have the same background. But I guess that comes down to their business judgment.

But I have difficulty in understanding your regulations when I come to compare large businesses and smaller businesses that would be dealing with the Department of Defense. Now, is there a difference in your approach to the smaller or medium-sized businesses as far as this process is concerned?

Ms. SPECTOR. The fact is, on negotiated contracts, we review the costs approximately the same way with large and small contractors. Now, that is not to say that we would disallow the cost of proposal advice to either a large or a small contractor. If we see what the individual is doing, if it is appropriate, if it is reasonable, our current provisions provide that it would be allowable.

Consultant costs by definition are not unallowable. Whether the contractor is large or small, if they cannot show a casual or beneficial relationship to a Government contract, DCAA would normally question the cost. That is not to say that when we get into negotiations with the contractor, he might not have further explanation, further documentation, to support his position. But approximately the same kinds of rules are applied when we look at large and small contractors. We look to see the reasonableness of the cost and that there is documentation supporting what the individual or firm was doing for the contractor.

Senator STEVENS. Thank you. I appreciate your statement concerning Secretary Carlucci. I think he has set an example for his successor in terms of his prompt recognition of the interests of those of us in the Congress in this subject and the manner in which he moved to aggressively attempt to change the Departmental procedures, particularly in light of some of the examples we have had in the last year with regard to activities of consultants. I think Secretary Carlucci has attempted to change the process that led to some of those glaring examples this past year. And we are grateful to him, at least I am, for what he did while he has been there. So I thank you for helping him.

Senator PRYOR. Ms. Spector, could you give us any off-the-record inside information as to who will be Mr. Carlucci's successor?

Ms. SPECTOR. I wondered if you might have some.

Senator PRYOR. Surely, you know.

Senator STEVENS. It won't be either you or me.

Ms. SPECTOR. I, myself, have not been asked. [Laughter.]

Senator PRYOR. Senator Bingaman?

Senator BINGAMAN. Thank you, Mr. Chairman.

Ms. Spector, I might have missed this in the earlier testimony, but I was here for most of it. What is the plan with regard to this $57 million of questionable costs now? Do those become unallowed, or what happens to them?

Ms. SPECTOR. Of the $57 million, $43 million has been charged to defense contracts. Of that amount, $19 million has been charged to flexibly-priced contracts. It is that $19 million that we have directed contracting officers to get back from contractors in the negotiation of overhead rates.

Senator BINGAMAN. So that will be recovered, that $19 million?

Ms. SPECTOR. Yes, sir. It is not completely clear that we have paid the remainder. Bear in mind it was on fixed-price contracts. If we had negotiated the overhead rate sufficiently low—as I hope we did in most of those cases—unallowables would have been excluded from those contracts by definition. So it is not clear that we paid the remainder. Those were the amounts charged to the contracts. Bear in mind, there are amounts charged that could result in an overrun, for instance, to a contract that technically we would not pay.

Senator BINGAMAN. I see. So some of the $43 million may not have been charged to the Government; you are saying it may have been charged to a contract.

Ms. SPECTOR. It may have been charged to a contract conceivably, if the contract was overrunning, for instance, already; or in a situation where the overhead rate at the initial negotiation was established sufficiently low to exclude all unallowables, which is what we try to do. It is again possible that there was no amount included in that original contract in the price for this.

Now, of course, we also would not be paying it as part of billing rates. So effectively, in that situation, it would come out of his profit.

Senator BINGAMAN. We should expect that as a result of this audit report that the Government will be reimbursed or will be in a position to refuse payment of $19 million that would otherwise have been charged.

Ms. SPECTOR. Very possibly. It might not have been charged. If the rates were set low enough. We would certainly exclude it from our final negotiation of overhead rates for those years, for 1986 and 1987, with the contractors involved, yes, sir.

Senator BINGAMAN. Now, that was for 12 contractors that they went out and checked.

Ms. SPECTOR. Yes.

Senator BINGAMAN. In your statement, you talk about the letter that Secretary Carlucci sent to the 200 largest defense contractors—the other 188 got a follow-up letter.

Ms. SPECTOR. Yes; all 200 did.

Senator BINGAMAN. Oh, all 200 did.

Ms. SPECTOR. The 12 got a special letter, and the other 188 also got a letter.

Senator BINGAMAN. Okay. What action is planned with regard to this 188 to try to catch the same problems that were caught with regard to these 12?

Ms. SPECTOR. As Mr. Reed mentioned, we are now auditing an additional 18 very large contractors for just this kind of problem. For some of the 200, it is not a major critical issue. For instance, there are fuel companies involved in those 200 where their work is all competitive. We do not scrutinize costs and competitive contracts where they win as low bidder or for other reasons.

I would assume that Bill Reed will give direction to DCAA to further scrutinize these kinds of costs and do it fairly carefully as part of the ongoing DCAA review by the people who review proposals and review overhead rates.

Senator BINGAMAN. Okay. So you would be fairly confident that these kinds of costs when charged by any of the 200 would be caught in the course of your normal DCAA auditing process, is that the expectation?

Ms. SPECTOR. I would hope so, yes. We have also sent out guidance to our contracting officers to be aware of what was in the audit and to look into getting the money back and correcting the internal control problems that existed at these contractors and probably can be assumed to exist at other contractors as well.

Senator BINGAMAN. Okay. The point that Mr. Reed made about the new 1987 regulation providing for the charging of penalties and interest on unallowable costs—that is by regulation?

Ms. SPECTOR. That is by law.

Senator BINGAMAN. So there is a statute that classifies that.

Ms. SPECTOR. Yes, sir.

Senator BINGAMAN. In your view, is that going to dissuade this kind of charging to a significant extent in the future? Is that going to be an effective deterrent?

Ms. SPECTOR. I would think that a lot of what we have done has already been an effective deterrent. Bear in mind, "Ill Wind" occurred in the middle of 1988. The costs that were audited of necessity are 1986 and 1987.

Talking to industry associations, the feel I am getting is they are doing a much more thorough job now of reviewing these kinds of costs, of questioning them. We heard of one fairly large contractor who fired all the consultants working for the contractor.

I would say that between that law, the overhead cost certification and, as Mr. Reed mentioned, the cases we have had, and "Ill Wind," I would say it has had a rather chastening effect on all of our contractors. They don't like their names appearing in the paper for doing the wrong thing; and the CEOs are the ones who are hurt by that, and the CEOs are the ones that I understand are starting to take very strict action in these areas.

Senator BINGAMAN. Does this overhead cost certification have any real teeth in it? It seems to me it is virtually impossible to make a case against somebody who signs such a certificate.

Ms. SPECTOR. It has to be signed at a very high level in the company; no lower than one step below the presidential level. People at that level are very reluctant to put their name on a certificate certifying something if they haven't done a thorough review. The information that I saw showed that questioned costs that companies

were certifying had dropped 50 percent in the unallowables area. Now, that wasn't data that covered all contractors, all certificates, and it was about a year or two ago that I saw the data, but it has had an effect on reducing the amount of questioned unallowable costs.

As Mr. Reed suggested, some of these costs, contractors will argue are not what we say they are. This is DCAA's view of what they are and we certainly try to sustain those at negotiations, but occasionally additional evidence is provided indicating that the claimed costs are more supportable than we initially thought.

Senator BINGAMAN. Does the overhead certification apply to all—I mean, is that something that is a part of all your contracts now?

Ms. SPECTOR. All contracts where we have negotiated overhead rates; all the large contractors where there are negotiated rates, indeed, yes, it does apply.

Senator BINGAMAN. Okay. In your view, is there anything more that should be done by way of changes in the law or changes in the regulations other than what you have already testified has been done, to build in a disincentive to contractors charging unallowable costs as DCAA has testified they did in these cases?

Ms. SPECTOR. I think our regulations are fairly strong on what is unallowable, and I think there is a pretty good understanding, as you have heard from contractors who resent all the auditing that is going on, that we are quite thoroughly auditing these kinds of costs. The likelihood that we will find them is reasonably good.

At this point, beyond tightening up the definition and the documentation required in the cost principle, I don't think we need additional regulations in this area on unallowables and on auditing more extensively. It remains an implementation problem. I do think there needs to be a more thorough review of why consultants are being used by CEOs and by people in positions of responsibility which I think is starting to occur. But that is critical. It is an implementation problem more than anything—making more things unallowable or having more auditing or more rules, at this point, does not appear to me to be the answer.

Senator BINGAMAN. Thank you very much, Mr. Chairman.

Senator PRYOR. Ms. Spector, were you surprised at any of the findings in the DCAA audit?

Ms. SPECTOR. I don't know that I was surprised. It was approximately what I might have expected and predicted. I suspected that documentation would be a problem. I cannot say that I would have predicted precise amounts, but when you audit approximately $50 billion worth of costs, that about $200 million is charged for this kind of service is probably not a great shock to me.

Senator PRYOR. If you were not surprised, why was it that you waited until you were mandated by Mr. Carlucci to look at these consulting costs? Why did you wait so long?

Ms. SPECTOR. I guess the surprise was not at the audit. I was surprised at the "Ill Wind" revelations, and it was the "Ill Wind" revelations that encouraged us to look at these kinds of areas.

I am on the working group, of course, that is supporting Mr. Carlucci in the areas that we should be focusing on.

Senator PRYOR. This is a post-"Ill Wind" operation.

Ms. SPECTOR. Yes, sir.

Senator PRYOR. This Congress and this Committee have been telling the Department of Defense for 10 years about consulting costs that are being passed onto the taxpayer. Now, why hasn't someone done something about this before we have a grand jury investigation of these contractors and these consultants? Why are we waiting so long? What is the matter?

Ms. SPECTOR. Sir, we really did not. There is coverage in the FAR already, and has been, on consultants who work directly for the Government, requiring contracting officers to investigate conflicts of interest and put clauses in contracts and in solicitations, delineating conflicts of interest. They are prohibited on our contracts and we won't do business with someone on particular service contracts where there are conflicts of interest. There is also a FAR cost principle.

Senator PRYOR. Now, there is no way to cross-check a consultant hired by a defense contractor to see if that consultant is working for the Department of Defense. Now, if there is, you tell me about it.

Ms. SPECTOR. You are correct, sir. However, before we award a contract to a services company or a particular consultant, the contracting officer checks to be sure there is no conflict of interest with the work he is performing for us. That is required by the FAR, and the contractor has to have a clause in his contract to that effect. That has been a requirement of the FAR for quite some time.

Senator PRYOR. You are talking about what I call "self-policing;" you call it "self-monitoring."

Ms. SPECTOR. It is more than "self." We make it a mandatory contractual provision in any contract where we buy services from the contractor—in some cases, we specify which companies he may not do business with, or what programs he may not do business on—and that is done before we award any contract for services that we award.

Senator PRYOR. Ms. Spector, what about some of the companies that are being looked at in the "Ill Wind" investigation, and we will not talk about specific names. When I asked Mr. Reed if any of these had been debarred, you were shaking your head. Now, I don't know whether you were agreeing or disagreeing. Have any been debarred?

Ms. SPECTOR. No, sir.

Senator PRYOR. Have any been suspended?

Ms. SPECTOR. Yes, sir to date, one company has been suspended.

Senator PRYOR. What is the normal suspension of a contractor? What is the length of time?

Ms. SPECTOR. Normally, it would occur when they are indicted for a contract-related action. That is normally when we would suspend them. We do for other reasons as well. In the case of "Ill Wind," we don't have in our hands any hard evidence as to what these contractors have done. What we have are newspaper articles and rumors.

We have done two things to protect our interests when dealing with those contractors, but neither has been debarment or suspension.

Senator PRYOR. Are you aware of this association of consultants who do work for the Government?

Ms. SPECTOR. There are several associations.

Senator PRYOR. Right. Do you know if any of these associations have adopted any policies of self-policing? Could you give me an example?

Ms. SPECTOR. I am not familiar, sir, with what they have done in that regard.

Senator PRYOR. Do you feel that the penalties and punishments are severe enough on these contractors who are trying to pass on these costs and charge them to the taxpayer?

Ms. SPECTOR. I believe currently the penalties probably are severe enough. I don't necessarily think it is lack of penalties that is causing this.

Senator PRYOR. Ms. Spector, why do you think Mr. Reed and Mr. Topf testified and stated in their written report that they got very little cooperation from the defense industry being audited?

Ms. SPECTOR. I couldn't guess the reasons, other than there is some reluctance to cooperate at times with auditors when they are coming in to do something that you don't like.

Senator PRYOR. For the 18 additional firms that are now being audited, how long will that audit take? I probably should have asked Mr. Reed that.

Ms. SPECTOR. Perhaps he can answer. I truly don't know, sir.

Mr. REED. The end of February.

Senator PRYOR. Do you have any recommendations to this Committee as to how we might tighten these potential conflicts of interest that we have?

Ms. SPECTOR. I would say that in the area of consultants working for prime contractors——

Senator PRYOR. And also working for the Department of Defense at the same time.

Ms. SPECTOR [continuing]. Yes, there are two areas.

Senator PRYOR. And/or working as foreign agents at the same time; and/or possible felons working for both at the same time.

Ms. SPECTOR. When OFPP was asked to put out the policy, we were working on revising our own policy to toughen it up a bit, if you will. We currently have a policy on this at Part 9.5 of the FAR, on organizational conflict of interest. I believe we need to work on the definition in that, and I believe we need to put out a draft clause, perhaps, that would protect against organizational conflict of interest.

The gist of the policy is certainly here, and it tells contracting officers to review the situation in any case they suspect there might be this sort of conflict of interest. I believe we have to tighten up our own rules on this. Again, we are waiting for the OFPP policy issuance on that.

Now, as far as the cost principle which applies to costs for consultants that contractors use, I think again, the definition needs to be tightened up, and we are indeed doing that; and I think the mandatory requirements of certain documentation need to be imposed, and we are doing that as well.

Senator PRYOR. How can we have a cross-checking system to know who is working for whom if we don't have some kind of registration? How do we do this?

Ms. SPECTOR. Sir, it is my belief that when we enter a contract with someone, we have to do everything that we need to do to assure ourselves he has no conflict of interest and is not a convicted felon or a person we do not want to deal with. Indeed, we must be very, very careful to do that.

With the contractors, we need to carefully and strenuously review whether the costs that they are incurring have a beneficial relationship to our Government contracts. Now, I believe those two things can be separate. I am not sure we need to impose upon DCAA the requirement to cross-reference.

I think the contracting officer who hires an advisory or assistance service for the Government needs to assure himself that that individual or firm has no conflict of interest.

Senator PRYOR. Now, I proposed registration legislation, and as I said, I was not successful. What were your feelings about this?

Ms. SPECTOR. We would support a registration that would be useful to the contracting officer in making his determinations. We did not necessarily oppose registration.

Senator PRYOR. Well, if I may interrupt, respectfully.

Ms. SPECTOR. Yes, sir.

Senator PRYOR. My distinguished colleague, a member of the Armed Services Committee, Senator John Warner of Virginia, on August 11, during the debate on this registration amendment, placed into the record a long summary of the Department of Defense's position on my amendment, Section 12 of my larger bill. I will take just a sentence or two. "Simply put, DOD has no need, desire or end use for registration. The penalty of suspension or debarment for failure to comply is totally contrary to its intended use."

Now, that doesn't sound like you all were very happy about getting some system of registration.

Ms. SPECTOR. The letter that I have is from Kathleen Buck, who is our General Counsel, and what she says is that the Department of Defense does not necessarily object to the concept of registration of consultants. "We could support a registration that was not unduly burdensome, that would elicit information necessary to enable us to identify potential conflicts of interest resulting from the work that a consultant undertakes for the Department and the work the consultant performs for others."

The letter that I recall did not categorically oppose registration. The registration needs to be available to and submitted to the contracting officer. We have contracting officers all over the world. A central bank may not have information on a real-time basis for the contracting officer. He needs to review for conflict of interest every time he awards a contract. I don't mind his forwarding that information to a central bank, but it needs to be made available to him when he makes his decision whether or not to award.

Senator PRYOR. I understand. Now, this $43 million that DCAA has found questionable, how much of that are we collecting?

Ms. SPECTOR. At least $19 million. It is not clear that we have necessarily paid the remainder. It was charged to Government con-

tracts. But if the delta between $43 and $19 million, let's say, was charged to a fixed-price contract that is overrunning, the contractor would not get any additional money on that contract, although of course he is required to charge to it. If the overhead rate initially was established low enough to exclude these kinds of unallowables—which I would hope it was—we would not be paying these kinds of costs on that contract.

Senator PRYOR. But until March 1987, and correct me if I am wrong, there was no real penalties for passing these costs on, is this correct?

Ms. SPECTOR. That is basically correct, yes, sir.

Senator PRYOR. We didn't even collect interest on what they owed us.

Ms. SPECTOR. No, we did not.

Senator PRYOR. Do you believe that the contractor has the burden of proof of proving their reasons for passing costs on to the taxpayer?

Ms. SPECTOR. Absolutely. That is another change we made to the cost principle, requiring that the burden of proof for unallowables be put on the contractor.

Senator PRYOR. The DCAA testified that for several years, they have discovered problems with consulting services, and we have talked about one of them today, and that is the definition. Is this the first time that the Department of Defense is really looking at consulting costs? Is this the first time, since "Ill Wind"?

Ms. SPECTOR. No, sir. We had two provisions in the FAR, one governing the consultants that we hire, and one, a cost principle on the consultants that contractors hire. Those provisions have existed for many, many years in the FAR, regulating both areas. What we focused on is whether they need to be tightened up in light of the "Ill Wind" findings, and that is what we have been focusing on, and whether our enforcement has been stringent enough—although we have been enforcing both of those provisions.

Senator PRYOR. I see. Now, Mr. Reed also testified that many of the consultants being employed by the defense contractors were former military personnel and civilians from the Department of Defense. What steps are you taking to make certain that these consultants are in compliance with the "revolving door" statutes now on the books?

Ms. SPECTOR. Sir, I am going to have to answer that for the record. It is not in my immediate area of oversight. It is in our Office of General Counsel, rather than in Procurement Oversight. My office doesn't oversee "revolving door" kinds of matters.

Senator PRYOR. If we could possibly get that statement answered for the record, I would deeply appreciate that.

Ms. SPECTOR. Yes, sir, we certainly shall.

[The information referred to follows:]

The Department places numerous restrictions on current and ex-government employees. These include limits on contacts with prospective employers, disqualification from certain duties in the event of a conflict of interest and various bars against employment with certain DoD contractors. Contractors who have contracts with DoD greater than $10 million are required to submit an annual report to the Secretary of Defense listing all former DoD employees and offices compensated by the contractor and to identify various aspects of their employment, including a complete description of their work on each major defense system. We then assess the

accuracy and completeness of the reports. There are also reports which must be filed by each ex-employee for a number of years after they leave DoD. We believe these steps adequately protect our interests in this area.

Senator PRYOR. Ms. Spector, are you familiar with a small office that was created recently called the Office of Operational Testing and Evaluation. It is Jack Krings' office, it is there to get an independent system for testing of weapons so that manufacturers and contractors won't be testing their own, are you somewhat familiar with it?

Ms. SPECTOR. I am certainly aware that it was created.

Senator PRYOR. Now, would it concern you if some of the consultants who were employed by the Office of Operational Testing and Evaluation were also employed by the contractor who manufactured the weapons? Would that be a conflict of interest?

Ms. SPECTOR. It could. It wouldn't by definition be, sir. For instance, the world's foremost expert on Stealth conceivably might be advising both sources. I couldn't unequivocally sav by definition it would be—it might be.

Senator PRYOR. One concern of mine is the Defense Science Board. I think potentially there are some major conflicts of interest there. Do you have any way to know if consultants who are hired by the Department of Defense, or by the contractors, are members of the Defense Science Board as consultants?

Ms. SPECTOR. Sir, I don't know.

Senator PRYOR. And if so, if they are in fact, would this be a conflict of interest?

Ms. SPECTOR. Again, I hesitate to say that by definition it would be, but it would be something that probably ought to be looked at.

Senator PRYOR. How does the Department of Defense encourage the defense contractors to strengthen their own internal system of monitoring consultant activities?

Ms. SPECTOR. Well, we have done it head-on by having Mr. Carlucci write directly to the CEOs and tell them they had better pay more attention in this area, because we certainly are. By asking our auditors to go in and focus on these sorts of areas forces the contractors to focus on those areas as well, probably more effectively than writing more policy does. We have always had the right to do it. The fact is, we now are doing it, and by asking our auditors and our contracting officers to focus heavily in this area, I would say we are forcing our contractors to do so as well.

Senator PRYOR. Do you have any final comments you'd like to make?

Ms. SPECTOR. No, sir.

Senator PRYOR. Well, once again, Ms. Spector, on behalf of the Committee, I thank you for coming. I am going to conclude the hearing, but I will say this. I do think that we've got a pretty serious problem. I think we have a lot of potential for conflict, and I think "Ill Wind" is probably going to show us in more detail how these relationships are formed. I think we have an old "buddy boy" network out there that is alive and well. It has been in a feeding frenzy for a number of years, and I am not talking about Republication Administration or Democrat, it has been going on a very, very long time. And until we have some light shining on the contractors and the consultants this world that very few of us know

about and cannot even define, can't account for, I think we are jeopardizing our national security, and I know we are jeopardizing the taxpayers.

I hope that you will cooperate with this Committee, and thank you very, very much.

The meeting is adjourned.

[Whereupon, at 11:35 a.m., the Subcommittee was adjourned.]

APPENDIX

REPORT OF AUDIT

SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

Contractor information contained in this report may be confidential The restrictions of 18 USC 1905 should be considered before this information is released to the public.

DEFENSE CONTRACT AUDIT AGENCY

24 OCTOBER 1988

FOR OFFICIAL USE ONLY

REPORT OF AUDIT
SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

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REPORT OF AUDIT
SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

EXECUTIVE SUMMARY

OBJECTIVE:

To determine the nature and extent of consulting costs charged to defense contracts by a representative sample of large defense contractors.

SCOPE:

Twelve of the largest defense contractors were selected for review representing a cross section of products and services, programs and DoD procurement activities. These companies received 32 percent of DoD prime contract awards in FY 1987. Audits were conducted at sixty segments of these twelve companies including applicable group headquarters and corporate offices. Costs were examined in the latest year for which a certified indirect cost claim had been received.

RESULTS:

DoD contracts of all types were charged for $237 million of professional fees and consultant costs during the period reviewed. $43 million of these costs are considered questionable, primarily because of contractors inability to provide adequate evidence of the nature and extent of services received. Questionable amounts charged to fixed-price contracts may indicate a need for better cost or pricing data supporting negotiated contracts, while $19 million of questionable cost being claimed for reimbursement in certified indirect cost submissions should be resolved during settlement of final indirect rates.

The current FAR cost principle is not effective in assuring that only allowable costs are claimed under DoD contracts.

Widespread contractor resistance was encountered to DCAA access to information on unclaimed cost needed to determine that contractors had screened out related directly associated costs, as required by FAR.

Numerous deficiencies were found in contractor controls for approval and monitoring of consultant costs.

RECOMMENDATIONS:

FAR 31.205-33 should be revised to (i) strengthen unallowability criteria, (ii) clarify the documentation required to support claimed cost, and (iii) better define professional fees and consultant costs.

Contracting officers responsible for settlement of final indirect cost rates should assure that $19 million of claimed cost is disallowed unless additional support is submitted and reviewed by DCAA.

Contracting officers and DCAA auditors at individual contractor locations need to aggressively pursue contractor correction of internal control weaknesses over the approval and control of consultant costs and cost estimating procedures used to propose such costs.

Contracting officers should assure that contractors fulfill their responsibilities to delete unallowable cost from their claims to the government in accordance with FAR 31.201-6 and to demonstrate to DCAA that such screening properly deleted directly associated costs as well as the unallowable costs themselves.

REPORT OF AUDIT
SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

BACKGROUND

The Secretary of Defense, Frank Carlucci, in a memorandum dated 25 July 1988, directed that the Defense Contract Audit Agency (DCAA) establish a Special Audit Task Force to conduct an audit of contractor consulting costs. He further directed that the review should include a representative sample of large defense contractors to determine the nature and extent of consulting costs being charged to defense contracts and that the results should be reported to the Under Secretary of Defense for Acquisition as soon as possible.

We selected for review 12 companies from the top 100 defense contractors. They received 32 percent of prime defense contract awards in Fiscal Year 1987 and supply a wide variety of goods and services to the Army, Navy and Air Force. They also rank in the top 25 defense contractors in terms of cost reimbursable and fixed price incentive contracts. The 12 companies are listed in Appendix I.

Within the 12 selected companies, we chose for examination those segments with the most significant incurred costs on cost reimbursable and fixed price incentive contracts, the group headquarters, if applicable, and the corporate office. A detailed examination was made of those costs included in the latest year for which a certified incurred cost claim had been received when our review began in early August 1988.

At the onset of our review, we encountered significant difficulty in isolating "consulting" services and costs due to the lack of a universally accepted definition of the term. The Federal Acquisition Regulation (FAR) 31.205-33, the governing cost principle, addresses professional service costs together with consultant costs without distinguishing between the two. Further, contractors had no routine means of separately identifying nor accumulating these costs. Consequently, we determined that all costs covered by FAR 31.205-33 should be examined in order to reduce the risk that a misunderstood definition would result in the exclusion of pertinent items.

We requested contractors to identify and list all professional service and consultant costs incurred for the most current incurred cost claim year, including direct and indirect charges and amounts not claimed. Even under the broad definition of FAR, considerable difficulties were encountered in identifying all professional service and consultant costs since some of the contractors' accounting systems did not provide for accumulation of such costs in a separate account. Both direct and indirect consultant costs were frequently commingled with other types of costs. For example, some contractors charged consultant costs to overhead accounts which included outside services such as job shop labor, janitorial services, etc. which are not covered by the FAR definition. Contractors were generally cooperative in attempting to identify the costs but in some cases they declined to categorize the costs as to the nature of the services provided. In these cases, the auditors performed the categorization. We reviewed and tested the contractors' methods of accumulating the data and tested the results against other available sources of

information. We believe that we were ultimately able to identify substantially all such costs incurred even though we're not certain that the categorical breakdowns of the totals are completely accurate (see paragraph B of Results of Audit and Exhibit B.).

SCOPE

A. Our examination was performed in accordance with generally accepted government auditing standards and included such tests of the contractors' data and records and other auditing procedures considered necessary in the circumstances. Because the audit was requested as a result of the recent disclosures related to the Department of Justice (DoJ) Operation Ill Wind, we afforded priority attention to the examination of payments to those consultants and consulting firms mentioned in applicable news articles and to costs attributable to selling, marketing and lobbying activities.

B. Investigatory methods are beyond the scope of auditing procedures and were not applied in this review. Therefore, we placed principle reliance upon contractor supplied documentation - primarily, the (i) agreement (contract) between the contractor and the entity performing the service, (ii) work products, and (iii) billing documents - to determine the nature of the costs and whether the costs were allowable per FAR 31.205-33. Absent some indication in that documentation or a clear inference from it, we had no means to ascertain whether the services involved the possible exertion of improper influence on the acquisition process. Many of the files we requested were pre-reviewed by the contractors, and we were usually given, at best, only the three documents previously described. In the case of costs deemed questionable for a lack of support, not even the three primary documents were available for review. Consequently, we have little confidence that we had an opportunity to find indications of suspect practices.

C. FAR 31.201-6 requires contractors to identify expressly unallowable and directly associated costs. To avoid delay in completing the audit, we did not attempt to identify most unallowable directly associated costs attributable to either (i) contractor unclaimed costs, or (ii) costs we deemed questionable as a result of our audit. Consequently, our questionable costs are understated to some extent. We do not believe that this understatement significantly impairs the utility of our results for purposes of answering the Secretary's expressed concerns. However, we anticipate significant problems in identifying directly associated costs applicable to unclaimed costs when we pursue final resolution of allowable costs since nearly all contractors showed great reluctance to provide sufficient information to permit necessary analysis and determination of appropriate cost treatment. (See paragraph A of Results of Audit and Exhibit B.)

RESULTS OF AUDIT

A. Summary

We found that contractors were spending considerable sums supplementing and complementing virtually every in-house activity with professional and consultant services. In light of the difficulties experienced by the contractors in accumulating data and supplying supporting documentation to us, it became clear early in our audit that centralized contractor control and oversight over the incurrence of such costs did not exist except at a few isolated contractor segments. This was confirmed by the fact that a sizeable number of the numerous transactions involved were supported by sketchy or non-existent documentation and subject to little demonstrated internal control. The frequent absence of substantive compliance with the documentary requirements of the Federal Acquisition Regulations prevented us from determining the nature of these expenditures and led us to conclude that the disciplines necessary to preclude and discourage questionable expenditures were, in most cases, non-existent. Further, the reluctance frequently expressed by many of the contractors to acknowledge the requirement for such disciplines and documentation and, in some cases, to acknowledge our routine right to review the available documentation supporting claimed costs indicates a need for clarification of the government's minimum requirements for accepting these costs. Adoption and enforcement of the provisions in the exposure draft change to FAR 31.205-33 approved for public comment, after incorporation of our recommended modification, would correct most of the deficiencies we observed. Further, we think that contractors should be forcefully reminded of the requirements of FAR 31.201-6, "Accounting for Unallowable Costs", and the need for DCAA to obtain sufficient access to assure that those requirements are reflected in contractor claims.

The ensuing paragraphs set forth our findings and conclusions regarding the nature and scope of consultant and professional service costs, the allowability of claimed costs and shortcomings in internal controls. Appendix II contains the exposure draft of the proposed revision to FAR 31.205-33 and our recommended modification to assure adequate documentation.

B. Nature and Scope of Consulting Costs

Using the definition of consulting costs previously described - all consultant and professional service costs - the following tabulation sets forth the kinds and dollar values of consulting costs charged to defense contracts, including Foreign Military Sales, in the latest year for which a certified cost claim had been submitted at the selected locations of the 12 contractors included in the review. It should be noted that we relied on available contractor information for this data.

Category	Amount
Lobbyists	$ 823,192
Sales/Marketing	17,235,680
Management Services	33,186,504
Legal	25,842,832
Technical/Engineering	118,562,295
Accounting, Auditing, Actuary, Insurance	19,539,161
Other (Principally recruitment, training, medical services and unidentified by contractor)	21,311,085
Total	$ 236,500,749

We estimated that the foregoing total was distributed among types of contracts as follows:

Type	Amount
Foreign Military Sales	$ 16,945,421
Firm Fixed Price	90,985,124
Incentive and Cost Type (Flexibly priced)	128,570,204
Total	$ 236,500,749

(See Exhibit C for detail of costs by contractor)

The above amounts are net of unclaimed costs.
(Exhibits B and C.)

Our review disclosed that contractors purchase services to supplement and complement in-house capability in virtually every direct and indirect function. The extent and dollar value of such services are very important in considering the results of our examination into the allowability of such costs and the need for a change to the FAR.

As indicated in paragraph A, Summary, the absence of adequate documentation prevented us from learning the exact nature of certain of the transactions reflected above.

C. Allowability of Claimed Costs

The results of our review of claimed costs are set forth in detail in Exhibits A and D. The following observations are pertinent:

1. Costs were reviewed for allowability regardless of the type of contract being charged. Charges to firm-fixed-price contracts are not subject to audit for allowability in accordance with applicable FAR provisions. However, FAR cost principles are applicable as a guide in the auditors evaluation of cost or pricing data used to negotiate firm-fixed-price contracts. The adequacy of cost or pricing data submitted in support of proposed professional fees and consulting cost will be pursued during future DCAA reviews of contractor cost estimating systems.

2. The principle reason costs were considered questionable was the absence of adequate consulting and service agreements and evidence of services rendered. In many of these cases, the agreements were too vague to disclose the specific nature and scope of services to be provided. Moreover, despite the requirement of FAR 31.205-33(e), "... fees for services rendered shall be allowable only when supported by evidence of the nature and scope of the service furnished...", we identified a significant number of instances where contractors did not locate and furnish significant work products or other evidence, even with the special impetus provided by the Secretary of Defense's inquiry. Because of the amounts of money involved, the opportunities for needless expenditures, and the potential for contractors obtaining questionable services, as alleged in the Operation Ill Wind investigation, we recommend the Department establish more stringent FAR requirements regarding support for

claimed costs. Once established, these can serve as the basis for more effective contractor internal oversight and enable routine monitoring by contracting officers and DCAA. We believe the exposure draft change to FAR 31.205-33 approved for public comment can, with our recommended modification, effect the changes needed. See Appendix II.

3. In the numerous cases where acceptable work products or other evidence of services rendered were not available, we were precluded from reaching any conclusion on the presence or absence in claimed costs of amounts related to potentially improper or unlawful activities. (See paragraph B. of the Scope section). At five locations we encountered specific facts which caused us to suspect irregular activity and referred the matters to the appropriate investigative agencies. However, as indicated, there were many cases where documentation supporting claimed or unclaimed cost was so sparse that it precluded any conclusions regarding the propriety of activities performed. Further, several payments to consultants and consulting firms mentioned in news articles relative to DoJ Operation Ill Wind were found during our reviews of claimed as well as unclaimed costs. Where these were included in claimed costs, most were deemed questionable for lack of support as to the nature and scope of services furnished. One of the contractors submitted a Voluntary Disclosure to the DoD IG which directly impacted the costs we audited. (See also Note 2.b., Exhibit A.)

4. We noted during our review that many of the consultants were former high level DoD military and civilian personnel and that many of the costs deemed questionable because of a lack of support involved services by those personnel. In a number of instances, information available from the contractors indicated that these individuals' services required extensive interface with personnel in the employ of DoD. It is particularly important in these instances that contractors assure that documentation clearly delineates the nature and extent of these services.

D. Internal Controls

We found some examples of weaknesses in every significant area of internal control. These weaknesses are summarized below. We've indicated parenthetically the number of companies of the 12 examined where we found each problem at one audit site or more. The on site DCAA auditors through their contracting officers will pursue corrective actions.

1. Determination of need, selection of source, determination of fee, monitoring of service, all performed by a single individual or organization. (10)

2. Absence of a written contract. (7)

3. Description of services to be performed inadequate to (i) ascertain appropriate accounting treatment, (ii) monitor performance, (iii) determine allowability, or (iv) identify whether the fee is a retainer or for services. (12)

4. Absence of documentation demonstrating that service was unavailable in-house or that such availability was considered. (8)

5. Absence of evidence of competition in selection of firm. (7)

6. Absence of evidence that fees were reasonable in view of services procured. (7)

7. Lack of an adequate accounting review to ascertain accuracy of accounting classification. (10)

8. Failure to adhere to existing company policies and procedures. (11)

9. Failure of internal audit to examine operation of internal controls in the area. (8)

CONTRACTORS' RESPONSE

We held exit conferences at each of the audit sites to discuss the results of our audit. Contractor representatives agreed that $3.5 million of costs were unallowable but expressed nonconcurrence or withheld comment as to other costs pending further review. Where we deemed costs questionable for a lack of supporting documentation - Exhibit A - many contractors indicated they were still searching and believed more support would be found.

DEFENSE CONTRACT AUDIT AGENCY

BERNARD TOPF
Task Force Director

EXHIBIT A
Page 1 of 3

SPECIAL AUDIT TASK FORCE ON CONTRACTOR CONSULTING COSTS

SUMMARY OF QUESTIONABLE COSTS

Nature of Questionable Costs	Amount (Note 1)	
Lack of Adequate Agreement/Work Product (Note 2)	$ 37,048,004	
Unjustified Retainer Fee	288,933	
Organization/Reorganization Costs	834,137	
Defense Against Government Claims/Appeals	575,736	
Prosecution of Claims Against Government	24,611	
Defense of Fraud Proceedings (Note 3)	2,162,231	
Unallowable Public Relations/Advertising	198,983	
Entertainment	34,469	
Foreign Selling Costs (Note 4)	3,641,406	
Unallowable Sellers'/Agents' Fees	8,535	
Legislative Lobbying Costs	972,315	
Executive Lobbying Costs	56,669	
Financial Costs	145,089	
Other (Note 5)	8,774,205	
Reclassified (Note 6)	2,796,457	
Total	$ 57,561,780	
Charged Direct	$ 11,622,190	
Charged Indirect (Overhead)	45,939,590	(Exhibit D)
Total	$ 57,561,780	
Estimated Amount Charged to DoD Contracts	$ 43,000,000*	

*Includes Foreign Military Sales, firm fixed price and flexibly priced DoD contracts.

Notes

1. The indicated amounts do not include applicable overheads and directly associated costs.

2. a. Most of these questionable expenditures represent claimed costs where the contractor did not produce evidence of services rendered, or, to a lesser degree, could produce no written agreements. We were surprised that the contractors did not have more readily available evidence of work performed than was furnished our auditors if only to internally justify the significant expenditures at issue. Some of the items also appear to be questionable under other FAR provisions. In a number of cases contractors believe that they will ultimately be able to locate and produce "acceptable proof" of work performed. We recognize that there will be instances where contractors will eventually produce additional support. Such untimely evidence will have to be subjected to careful scrutiny and perhaps given less creditability than documentation generated, maintained and furnished to the auditors in the normal course of business. Any documentation prepared after the fact would be particularly suspect and unreliable.

b. At one division at each of two companies, we questioned all professional service and consultant costs, totaling $13.4 million, because of the absence of adequate agreements and evidence of services rendered. At one division, with $6.8 million in costs, the available documentation we examined was not adequate. Further, the contractor had submitted a Voluntary Disclosure to the DoD IG alleging that fraud had been present in a variety of professional service and consultant transactions. However, our review indicated that the contractor had not identified all transactions which were involved with the improper activity. In the circumstances, we have no assurance that any costs are valid.

3. Legal expenses incurred in defense of fraud where the contractor could not yet provide evidence that the cases had been settled on terms which would make the costs allowable. In one instance involving significant expenditures, the costs had not been segregated as required by FAR.

4. Costs are considered questionable for DoD contracts under FAR 31-205.38(c) and (f).

5. Consultant and professional service costs questionable under a variety of FAR and CAS provisions. Some of the largest items were as follows:

a. Fees benefiting only commercial product lines.

b. Charges expensed rather than capitalized for software modification, installation and implementation. The basic software costs themselves had been capitalized.

c. Foreign selling costs incurred at a corporate office allocated to divisions not benefiting from them.

d. Unsupported consultant expenses, travel costs in excess of allowable ceilings and bad debt expenses.

6. Includes only audit recommended reclassifications with a cost impact. The largest single category was costs charged to overhead which we believe should have been charged to IR&D/B&P. Since the contractors' IR&D/B&P costs were overceiling, these costs should have been voluntarily deleted together with applicable overhead costs (not calculated). Also included are costs which should have been charged direct to commercial contracts.

EXHIBIT B
Page 1 of 2

SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

SUMMARY OF UNCLAIMED CONSULTANT AND
PROFESSIONAL SERVICE COSTS

(Note 1)

Contractor Rationale for Unallowability	Amount
Lack of Adequate Agreement/Work Product	$ 68,000
Unjustified Retainer Fee	1,575,551
Organization/Reorganization Costs	2,296,994
Defense Against Government Claims/Appeals	2,934,738
Prosecution of Claims Against Government	1,055,981
Unallowable Patent Costs (Note 2)	33,143,587
Defense of Fraud Proceedings (Note 3)	13,667,398
Other Unallowable Legal Costs	18,658,048
Unallowable Accounting Fees	4,073,199
Unallowable Public Relations/Advertising	5,402,903
Entertainment	90,696
Foreign Selling Costs	7,168,263
Unallowable Sellers'/Agents' Fees	7,021,839
Legislative Lobbying Costs	2,998,080
Executive Lobbying Costs	1,035,587
Financial Costs	495,195
IR&D/B&P Overceiling	5,117,750
Environmental Cleanup	3,227,784
Miscellaneous (Note 4)	2,887,736
Subtotal	$ 112,919,329
Balance of Unclaimed Costs (Note 5)	17,080,123
Total	$ 129,999,452

Notes

1. We asked contractors to classify their unclaimed consultant and professional service costs according to the rationale used to determine such costs were unallowable. We were only partly successful. See Note 5.

2. The majority of these costs were incurred at one contractor's corporate office and relate to commercial patent infringement suits.

3. The allowability of these costs will be determined by the resolution of the charges against the contractors. If the charges result in conviction, judgment against the contractors, their agents or employees, or decisions to debar or suspend, or are resolved by consent or compromise, the costs are unallowable per FAR 31.205-47.

4. These costs related to a variety of FAR provisions covering expressly unallowable items.

5. Contractors were either unwilling or unable to classify these costs as to the reason they were unallowable.

EXHIBIT C
Page 1 of 1

SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

UNCLAIMED AND TOTAL DOD
CONSULTING COSTS BY CONTRACTOR

Contractor	Unclaimed Consultant and Professional Service Costs (Exhibit B)	Consultant and Professional Service Costs Charged to DoD Contracts*
Boeing Company, Inc.	$	
General Dynamics Corp.		
Hughes Aircraft Co.		
International Business Machines, Inc.		
Litton Industries, Inc.		
Lockheed Corp.		
Martin Marietta Corp.		
McDonnell Douglas Corp.		
Northrop Corp.		
Raytheon Co.		
UNISYS Corp.		
United Technologies Corp.		
Total	$ 129,999,452	$ 236,500,749

*Based on available contractor data.
Includes Foreign Military Sales, firm fixed price and flexibly priced contracts.

EXHIBIT D
Page 1 of 1

SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

SUMMARY OF QUESTIONABLE INDIRECT (OVERHEAD) COSTS
BY CONTRACTOR

Contractor	Questionable Costs	Estimated Allocable to DoD Flexibly Priced Contracts
Boeing Company, Inc.		
General Dynamics Corp.		
Hughes Aircraft Co.		
International Business Machines Corp.		
Litton Industries, Inc.		
Lockheed Corp.		
Martin Marietta Corp.		
McDonnell Douglas Corp.		
Northrop Corp.		
Raytheon Co.		
UNISYS Corp.		
United Technologies Corp.		
Total	$ 45,939,590	$ 18,951,336

APPENDIX I
Page 1 of 1

SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

COMPANIES INCLUDED

Boeing Company, Inc.

General Dynamics Corp.

Hughes Aircraft Co.

International Business Machines Corp.

Litton Industries, Inc.

Lockheed Corp.

Martin Marietta Corp.

McDonnell Douglas Corp.

Northrop Corp.

Raytheon Co.

UNISYS Corp.

United Technologies Corp.

SPECIAL AUDIT TASK FORCE ON
CONTRACTOR CONSULTING COSTS

PROPOSED REVISION TO FAR 31.205-33 AND RECOMMENDED MODIFICATION

Proposed Revision to FAR 31.205-33
(Expected to be published for public comment)

31.205-33 Professional and consultant service costs.

(a) Definition. "Professional and consultant services," as used in this subpart, are those services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor. Examples include those services acquired by contractors or subcontractors in order to enhance their legal, economic, financial or technical positions. Professional and consultant services are generally acquired to obtain information, advice, opinions, alternatives, conclusions, recommendations, training, or direct assistance, such as studies, analyses, evaluations, liaison with Government officials, or other forms of representation.

(b) Costs of professional and consultant services are allowable subject to this paragraph and paragraphs (c) through (h) below when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see 31.205-30).

(c) Costs of professional and consultant services performed under any of the following circumstances are expressly unallowable:

(1) Services to obtain, distribute, or use information or data protected by law or agency regulation (e.g., See FAR 52.215-12, Restriction on Disclosure and Use of Data) unless the data or information was commonly available (e.g. news article or public testimony).

(2) Services that are intended to improperly influence the contents of solicitations, the evaluation of proposals or quotations, the selection of sources for contract award, whether award is by the Government, or by a prime contractor or subcontractor.

(3) Any other services obtained, performed, or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest, or similar misconduct.

(4) Services performed which are not consistent with the purpose and scope of the services contracted for or otherwise agreed to.

(d) Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with organization and reorganization (also see 31.205-27), defense of antitrust suits, defense against Government claims or appeals, or the prosecution of claims or appeals against the Government (see 33.201) are unallowable (but see 31.205-47). Such costs incurred in connection with patent infringement are unallowable unless otherwise provided for in the contract.

(e) Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with the defense or prosecution of lawsuits or appeals between contractors arising from either (1) an agreement or contract concerning a teaming arrangement, a joint venture, or similar arrangement of shared interest; or (2) dual sourcing, co-production, or similar programs, are unallowable, except when (i) incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer, or (ii) when agreed to in writing by the contracting officer.

(f) In determining the allowability of costs (including retainer fees) in a particular case, no single factor or any special combination of factors is necessarily determinative. However, the contracting officer shall consider the following factors, among others.

(1) The nature and scope of the service rendered in relation to the service required.

(2) The necessity of contracting for the service, considering the contractor's capability in the particular area.

(3) The past pattern of such costs, particularly in the years prior to the award of Government contracts.

(4) The impact of Government contracts on the contractor's business.

(5) Whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly when the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

(6) Whether the service can be performed more economically by employment rather than by contracting.

(7) The qualifications of the individual or concern rendering the service and the customary fee charged, especially on non-government contracts.

(8) Adequacy of the contractual agreement for the service (e.g., description of the service; estimate of time required; rate of compensation; termination provisions).

(g) Retainer fees to be allowable must be supported by evidence that -

(1) The services covered by the retainer agreement are necessary and customary;

(2) The level of past services justifies the amount of the retainer fees; (if no services were rendered, fees are not automatically unallowable); and

(3) The retainer fee is reasonable in comparison with maintaining an in-house capability to perform the covered services, when factors such as cost and level of expertise are considered;

(h) Fees for services rendered shall be allowable only when supported by evidence of the nature and scope of the service furnished. (Also see 31.205-38(g)). Such evidence may include, to the extent necessary to ensure that the work performed is proper and does not violate law or regulation:

(1) Details of all agreements (e.g., work requirements, rate of compensation, and nature and amount of other expenses, if any) with the individuals or organizations providing the services and details of actual services performed.

(2) Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided.

(3) Consultants' work products and related documents such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.

Recommended
Modification to DAR Committee
Approved Exposure Draft of
Change to FAR 31.205-33

Paragraph (g)

Add

(4) The actual services performed are documented in accordance with 31.205-33(h).

Paragraph (h)

(h) Fees for services rendered shall be allowable only when supported by evidence of the nature and scope of the service furnished. (Also see 31.205-38(g)). Such evidence ~~may~~ will include/ : ~~to the extent necessary/ to ensure that the work performed is proper and does not violate law or regulation/~~

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